

HOW TO SECURE  
CONTINUOUS SECURITY PROFITS  
IN  
MODERN MARKETS

By  
JOHN DURAND





**WITHDRAWN**  
**UTSA LIBRARIES**

# How to Secure Continuous Security Profits in Modern Markets

*by*  
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## Preface

The present work has been planned with the object of bringing together under one cover a considerable amount of fact and theory which it is hoped will be of practical value to our rapidly growing army of traders and investors. The past year has witnessed much acrimonious and ill informed controversy as to credit conditions and the true place of Wall Street in the country's economic progress. As an aid to understanding these complex questions there have been presented in Part I rather detailed descriptions of the machinery of Wall Street—how transactions in securities are handled, and how they are financed; together with a résumé of new developments in economics and finance which have created new standards for common stock values and wrought great changes in the character of our investment markets. In Part II are presented a number of practical methods by which traders and investors may profit by an understanding of these general principles.

Readers will find the material in Chapter IV of especial value as a means of determining whether individual stocks are actually under or overpriced in the present confused condition of the stock market. This is an amplification of a method of valuation which was first published about two years ago in *The Business of Trading in Stocks*, and which has since created a great deal of discussion.

International developments which may exert an influence upon investment conditions in this country have been given more than passing attention in the present work, especially as these are related to trans-

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fers of gold from one nation to another. As time goes on, and ocean distances are shortened by air travel and the radiophone, American investors will find it necessary to become more internationally minded in their study of economics and political questions. The need for a broader investment outlook is brought home to us even now by the tremendous growth in purchasing power created by the many investment trusts that have been organized within the past two years. The supply of very high grade common stocks is by no means inexhaustible, even in these great United States, and competitive purchases of stocks in this class on the part of our recently formed investment trusts have already so reduced the floating supply and raised prices that the broadest possible outlook is essential to successful investing.

FRANK ALBEE GIFFIN, M.A.

*September, 1929*

*New York City*

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## **Part I**

# **New Conditions That Control the Modern Stock Market**



# How to Secure Continuous Security Profits in Modern Markets

## CHAPTER I

### Preliminaries to an Understanding of the Modern Market

AS this is written, one of the greatest bull markets in history is in progress. People have been saying for several years that prices and brokers' loans are too high; yet they go on increasing. The facts are that in the present phase of this so-called "bull market," many stocks—perhaps the majority—have declined in market price. We are witnessing a highly discriminating market in which prices are endeavoring to adjust themselves more closely to intrinsic values than ever before in Wall Street history. In the process, stocks with improving earnings and prospects are rising rapidly; so that the result of these two cross currents this year to date (September, 1929) has been an almost stationary price level for the general averages, as depicted by THE MAGAZINE OF WALL STREET'S Common Stock Price Index.

People who deplore the high prices at which gilt edged common stocks are now selling apparently fail to grasp the fundamental distinction between investments yielding a fixed income and investments in the equities of growing companies. Nothing short

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of an industrial depression, which curtails earnings and destroys wealth, can prevent common stock equities in well managed and favorably circumstanced companies from increasing in value, and hence in market price. In Chapter IV it will be shown that the common stocks of steadily growing companies can well sell at twenty times their earnings, or even more, and yield only 2 to 3%, without being overvalued; whereas a preferred stock, with fixed income, should sell to yield 5 to 7%.

Suppose for a moment that it would be possible to pass and enforce a law prohibiting common stocks from selling on a current yield basis of less than 6%, and that earnings on a given common stock are increasing at the average annual rate of 6%. If earnings increase 6%, dividends will be increased at a like rate in the long run; and if dividends increase 6% a year, the law would obviously permit the stock's market price to rise 6% a year in order to keep the current yield down to the lawful 6%. Here then we would have the interesting anomaly of an investment which yielded 6% from dividends and another 6% from market appreciation—a true yield of 12% on an issue supposed to be prevented by law from yielding more than 6%. If common stocks of this character could be obtained to yield 12%, how could investors be induced to buy bonds and preferred stocks in quantity at a yield of only half to a third of that return? Such a law, devised to prevent the stock market from drawing funds away from "legitimate" business and investments, would make the advantages of growing common stocks as investments so evident to all, that there would be little demand for bonds and commercial paper.

On the other hand, it is shown in Chapter IV that, if common stocks are permitted to seek their true

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investment level, in free competition with other media, they will sell eventually on a true yield basis which is comparable to bonds and commercial loans, due allowance being made for supposed differences in risk. If permitted to remain at such levels, they would eventually find their way into the strong boxes of outright investors, and cease to figure in brokers' loans. But so long as stocks are forced by banking discrimination, destructive propaganda, credit stringency, and recurring industrial depressions to fall periodically below intrinsic values, there are bound to be recurrent periods of rapid recovery which place renewed strain upon our credit facilities, and sow the seeds of yet another progress checking business depression.

*The greatest economic problem of modern times is not how to hamstring the stock market, but how the means may be devised to permit stocks to sell for what they are worth and stay there.* Bear markets destroy incomparably more capital than was lost in the San Francisco earthquake and fire. In the aggregate they have probably been more costly to the world than war. To restore wealth destroyed by stock market panics necessarily draws heavily upon the world's credit resources, as it does to rebuild a city, or reconstruct a country's industrial and financial fabric after a devastating war. Permanent relief for credit can be obtained only by abolishing great catastrophes. Measures aimed to depress security values offer only a temporary remedy, and the cure is worse than the disease. It is, in fact, an enlightening commentary upon the inadequacy of our fiscal system, and the perverted logic of those who criticize Wall Street, that a bull market, which enhances wealth, should be looked upon as a disease; whereas a decline in prices, which destroys great wealth, is regarded

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with ill concealed satisfaction as a return to sanity and health.

In view of the appalling amount of uninformed discussion that is now prevalent about the workings of Wall Street and the money market, it has seemed opportune in this chapter to trace in some detail the path of a typical order to buy or sell stock, and see just how it influences the credit situation.

### How an Order Is Handled

Let us say that you are seated before a Translux screen and quotation board in the Chicago branch office of some New York Stock Exchange firm, and suddenly decide to purchase a hundred shares of U. S. Steel common "At the market." You fill out an order blank to that effect and hand it to the customers' manager, or to the order clerk. The latter makes a note of the order and at once passes it to the firm's telegraph operator, who transmits the order over your broker's private wire to the receiving operator in the New York Office. He in turn writes the order on a slip and hands it to the New York order clerk, who makes a memorandum of the number of your account and immediately telephones the order, over the firm's private wire, to the firm's clerk in its telephone booth on the floor of the Exchange. The booth clerk writes the order on a slip while pressing a button that uncovers the number of the firm's floor member on a great annunciator board on one wall of the Board Room.

The floor member keeps glancing at the annunciator and, as soon as his number is flashed, either goes in person to the telephone booth for the order or, if otherwise occupied, sends one of the many messengers who are always present on the Floor. A fast walk

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is all that is permitted on the floor of the Exchange. The broker receives the order, folded so that it can not be seen by anyone else, familiarizes himself with its purport, and proceeds to Post 2, which has been assigned by the Stock Exchange to all transactions in U. S. Steel. (Each of the many active listed stocks has a definite post around which brokers congregate to do business in that particular issue. Each post has a number of stocks assigned to it; for floor space is limited. Bonds, and a designated list of inactive stocks, are traded in at posts located in an adjoining room; and sales are reported over a separate ticker, known as the "Bond ticker.")

As Steel is a relatively active stock, our broker will ordinarily find a number of other brokers at Post 2, some bidding for Steel and others offering it for sale. That one of the many indicators on the post which is reserved for Steel will always show the price at which the latest transaction was closed; so that bids and offers do not need to specify the full figure—fractions are sufficient, and save time.

In this instance we shall assume that the last sale was at  $168\frac{5}{8}$ . "A half for 500," shouts some broker. "A thousand at  $\frac{5}{8}$ ," offers another; or, if he has only a hundred shares for sale, this may be abbreviated to: "At an eighth." If more than 100 shares are offered at  $\frac{5}{8}$ , our broker has one of two choices: he may "Stop" his intended purchase at  $\frac{5}{8}$ , i.e., he may arrange with the broker who is offering the stock at  $\frac{5}{8}$  to sell him a hundred if 100 shares or more are sold at that price, and then join forces with the other brokers who are bidding  $\frac{1}{2}$ .

The first broker to bid a given price is entitled to the first 100 shares sold at that price. If our broker succeeds in buying the 100 shares at  $\frac{1}{2}$ , the stop at  $\frac{5}{8}$  is automatically cancelled. The other al-

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ternative, if it does not seem advisable to stop the hundred at  $\frac{5}{8}$ , is for our broker to take the stock immediately at the offered price.

The method of handling a "Limit order," after it reaches the telephone clerk in the firm's booth on the Exchange floor, is somewhat different from the procedure with a market order. Upon receipt of a limit order, to buy or sell at a specified price and within a prescribed time, the telephone clerk may use his judgment (in the absence of instructions to the contrary) as to whether he will call the firm's floor member and hand him the order, or dispatch it by pneumatic tube to the "Specialist" who is always present at the post where the stock in question is traded in. If he gives it to the firm's floor member, the latter may decide that he is too busy to watch the order, and so turn it over to the specialist. The specialist enters all such orders on his book, opposite the appropriate price, with a notation showing how long the order is to remain in force. If your price is reached, the order will be filled; but only after all prior orders at that price have been filled. If only 500 shares are wanted at the price, and the specialist has aggregate orders to sell 500 shares at that price, received prior to your order, then your order will not be filled. Customers should bear this rule in mind when they see stock coming out on the tape at their price; but receive no report from their broker. The customary remark at such times: "He must have sold that stock for himself," is in bad taste.

### Odd Lots

The normal unit of trading on the New York Stock Exchange is 100 shares; though there is a fairly long list of inactive stocks, in charge of specialists at the

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bond posts, in which the unit of trading is 10 shares. Stocks selling under \$10 are not included in this list. People who buy or sell these special stocks should take care to submit a bid, or offer, and not trust to a market order; for the spread between bid and ask prices in such issues may be very wide.

The method of filling orders in "Odd lots" (any number of shares less than the Stock Exchange's normal unit of trading) differs considerably from the methods previously described. Here the firm's telephone clerk, at the booth which it rents on the floor of the Exchange, writes on the back of the order slip the name of some firm that specializes in filling odd lot orders for other members, then hands the slip to a representative of the odd lot house so designated. This member of the Exchange watches for the next sale, and fills the order at "an eighth away," if it is a market order. (In a few high priced and rather inactive stocks, the order will be filled "a quarter away.") If a limit order, the stock will have to sell an eighth (or a quarter) beyond the customer's limit before the order is filled. Stop orders are filled at an eighth (or a quarter) away from the first sale that makes the stop order operative. One to nine share orders in the Exchange's special inactive list (normal trading unit 10 shares) are filled a half point away, if the price is under \$125; otherwise, one point away.

### Reporting the Transaction

As soon as the broker fills your order, he will enter the report on a slip, with the name of the broker from whom the stock was purchased, and either take this himself, or dispatch it by messenger, to your firm's telephone clerk at its booth on the Floor. Thence the report is sent back to you over the route traveled by

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the original order. Should there be unusual delay in receiving a report on the transaction, the order clerk will phone to the floor for an explanation.

The Stock Exchange employs a number of uniformed reporters who make their way into the various groups of floor members and, pad and pencil in hand, make notes of every transaction as it is closed. Each transaction, or string of transactions, in a given security is entered on a separate slip of paper, stating merely the name of the issue, the volume that changed hands, and the price. As fast as these memorandum slips are written out they are taken or dispatched by messenger, to one of the five ticker operators seated at sending machines (like typewriters) which actuate the quotation tickers that are installed in members' offices in the Wall Street section of New York City. The Western Union Telegraph Company, under agreement with the New York Quotation Company which operates the local tickers, picks up the quotations from one of these tickers and flashes it over its own ticker system to all important cities in the United States. During periods of great activity, volumes are omitted from the ticker; but the original sales reports go to statistical clerks employed by the Exchange, who foot up the day's totals for each issue, and promptly send this information to the daily newspapers.

When a stock is very active, transactions may be going on simultaneously at different prices in various sections of the big crowd of brokers congregated about its post; so that there can be no certainty that the order in which quotations appear on the tape is the exact sequence in which they were actually closed on the Floor.

A person who is absent from the broker's office at the time his order is filled can verify the reported

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price of execution only by comparing with the tape of that day's transactions, or with the so-called "Official sheet" that is supplied daily to members of the Exchange by a private publisher. Time is printed on the tape at fifteen-minute intervals, but brokers seldom keep old tapes after the current day's business is over. The "Official sheet" is usually filed for at least a week; but time is not so closely indicated thereon, and transactions are sometimes "bunched"; so that it does not afford a very accurate check.

### Deliveries

*When stocks and bonds are purchased on any exchange, the broker has to pay for them in full, regardless of whether his customers elect to take up the certificates or carry them on margin.* In the instance of short sales, the broker must borrow the stock from some owner who is willing to loan the certificate, and delivery is then made to the buyer's broker, who pays cash in full for the stock. The seller's broker then loans all this money to the owner from whom he borrows the stock. When the short trade is covered, this process is reversed. The stock purchased is received from the seller's broker and returned to the person who loaned it; whereupon the latter returns the money borrowed on the certificate loaned, and this money is paid to the seller's broker in settlement of the transaction. When you sell short, the machinery that is set in motion is just as though you had induced some outside owner of the stock (the one who lends the certificate) to sell to a third party for cash and then repurchase at your bidding, with the understanding that you were to make good any resulting loss or receive any profit that might arise from the trans-

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action. The lender's compensation for being so obliging is that he has the temporary use of an amount of cash equal to the market value of his stock at a comparatively low rate of interest, or sometimes none at all.

When securities are sold on the New York Stock Exchange "Regular way," it means that they must be delivered to the purchaser's broker, and cash in full received from him, before 2:15 P.M. on the next full trading day. If the customer who ordered the sale does not produce his certificates in time, then his broker must borrow a like number of shares for delivery, which leaves the broker "Technically short" of the stock until such time as the seller actually surrenders his certificate. When the seller knows that there will be a delay in delivering his certificate, he may sell "at three days," i.e., for delivery upon the third day following date of sale; or at "Seller's option," i.e., to be delivered within a specified number of days—not less than four nor more than sixty. If either form of "Delayed delivery" option falls due on a holiday or half-holiday, observed by the Exchange, delivery must be made before 2:15 P.M. on the preceding full business day: except that when two or more consecutive days are holidays or half-holidays, contracts falling due on other than the first of such days must be settled on the next full business day. Similarly, the purchaser who is not prepared to pay cash for the securities if delivered "Regular way," may buy "At three days," or "Buyer's option." Where securities are bought or sold for "Cash," they must be delivered and paid for before 2:15 P.M. of the same day (11:30 on half-holidays). Bonds sold "Seller's option" may be delivered prior to maturity of the contract by giving one day's notice in advance, at or prior to 2:15 P.M.

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### Margin

Buying stock and bonds on margin is something like purchasing real estate that carries a mortgage. Cash paid on the real property corresponds to the margin deposited with your broker on the personal property and, in both instances, represents your equity in the investment. The mortgage constitutes your indebtedness on the property, and corresponds to the balance due your broker on the difference between the cost of the security and your cash equity. Both forms of property must be paid for in full; but indebtedness on the real estate is discharged with funds raised from sale of the mortgage; whereas the cash balance due on stocks and bonds must be paid by the broker—partly out of his own cash capital, and partly with money borrowed on your securities as collateral. The money borrowed on the broker's note with your securities as collateral, corresponds to money borrowed on bond and mortgage with your real estate pledged as security.

The mortgage has to be paid, or renewed at additional expense, on the definite date when it falls due; but your indebtedness to the broker need not be paid until the property is sold, when he deducts what is due him and then credits you with the remainder of what the securities brought. But there is a further important difference between carrying stocks and real estate on margin. If the real property declines in market value subsequent to your purchase, the mortgagee will not call for margin, i.e., will not insist that you pay off part of the mortgage to protect his interest (save for such amortization payments, if any, as may have been provided for in the indenture under which the mortgage was issued) so long as you keep up the interest payments, and pay off the principal

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when due. Of course, when you come to renew the mortgage, it will probably be made out for a reduced amount if the property has depreciated much in value. But the broker will immediately demand more margin to safeguard his collateral loan to you, if the price declines enough to seriously impair your equity.

The rate of interest on the mortgage is fixed; whereas the rate charged by your broker will fluctuate from month to month with the money market, which determines how much interest your broker has to pay in turn upon his borrowings at the bank. Usually the average rate charged to customers will lie somewhere between call and time money rates. On small or inactive accounts it will be larger.

The amount of margin demanded on stocks and bonds depends upon the broker, upon the type of security, the supposed responsibility of the customer, and the condition of the market. Generally, less margin will be required of customers whose accounts are large and active, who are always within reach of the telephone, and who are known to be financially responsible—especially if part of their long stock is hedged with short commitments. Some brokers are less exacting than others, partly because they have more of their own capital to draw upon. All will require more margin on the wild fluctuators than on the more sedate stocks, and greater protection when the market appears to be in a state of unstable equilibrium than when it is quiet and not over-manipulated in either direction.

It should be remembered that the firm can borrow on your collateral only a limited amount of cash, an amount which diminishes with each shrinkage in market value, and must advance the difference from its own capital. On many Curb stocks, most unlisted issues, and even on some New York Stock Exchange

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collateral in times of demoralized markets or stringent money, the firm may be able to borrow little or nothing. Consequently low priced stocks, volatile specialties with a thin market, and other securities which are not good collateral at the bank, have to be purchased outright. The same applies to manipulated issues of which a pool controls practically all the floating supply and has forced the price up to dizzy heights without regard for its intrinsic worth. If the pool has been doing this under special arrangements with some bank for accommodation, its bank may suddenly take cognizance of the unhealthy situation and call the pool's loans on that stock. Obviously this can only result in a crash, for no other bank would contemplate accepting the stock as collateral.

A broker may or may not demand margin on "when issued" trades. No money actually changes hands on these, as a rule, until the new stock is delivered; but the margin may be necessary as a guarantee that the customer will protect his broker against any loss that might arise from fluctuations in market price. Sometimes, however, the other party to the transaction will demand that the broker actually deposit a sum of money with some trust company, if the market has moved far away from the price named in the contract. Regular margin is also required on trades protected by Puts or Calls, if carried over to the next delivery day; for your broker cannot be expected to supply all the money to carry the stock, and there is always a possibility that the maker of the Option might repudiate, or be unable to fulfill, his agreement.

Most brokers will explain to a new customer, when opening an account, that initial margin requirements must be kept good. But many brokers, once they know a customer and acquire confidence in his financial responsibility, will permit the initial protection

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to shrink at least 50% before calling for more margin. In other words, a 40-point margin might shrink to 20 points before the broker would demand that it be brought up to 40 points again. The customer can respond in three ways to the demand for more margin: he may actually produce the amount of margin demanded; close out enough open trades to restore the impaired equity in remaining trades; or, with consent of his broker, place Stop Orders on open trades at such points as to safeguard the account from being wiped out by further adverse price movements. When resorting to the latter expedient, it should be observed that Stop Orders cannot be placed at the exhaust point; for a Stop Order becomes a market order when its price is reached, and a further loss of several points may be sustained in executing the order. In ordinary markets, the broker would probably consider it sufficient protection if Stop Orders were placed four or five points away from the exhaust point. Such Stop Orders must, of course, be kept in force so long as your margin is below that required by the broker, and no new commitments may be made in the meanwhile. In times of stress, however, Stop Orders will not be accepted in lieu of margin.

It is safest, and generally the most profitable in the long run, to trade with a firm which insists upon ample margins. This not only contributes to peace of mind, and safeguards your account from being wiped out by unexpected developments; but also protects the firm's capital, and so renders it highly improbable that your account would ever become involved in a brokerage failure. It is well to bear in mind that a firm which will permit *you* to operate on inadequate margin, will also permit other customers to do likewise; and this may force an assignment under stress of some crisis.

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### Speculation and Investment

It does not necessarily follow that a person is investing just because he buys outright, or speculating when he carries securities on margin with a broker or through a loan obtained directly from a bank with the certificates as collateral security. Many people entertain curious illusions about this. They seem to think that the distinction between investment and speculation is wholly a matter of risk; and that all margin purchases are risky, whereas buying outright and locking the certificates in their strong box makes it safe. "I never speculate": they will announce. "I always pay cash for my stocks and bonds." A moment's reflection, however, will show that the mere act of buying outright does not prevent a security from declining in market price, or passing its dividend or interest payments, or even becoming absolutely worthless. On the other hand, it could scarcely be called risky to borrow \$5,000 at the bank on \$10,000 worth of Liberty Bonds, yet this is carrying the bonds on margin.

*The true difference between investment and speculation is largely a matter of intent. If the purchaser is looking for income only, he is an investor; but if he aims to increase his principal through an expected rise in market price, he is a speculator—quite regardless of his equity in the transaction. One can invest on margin, by putting up the security as collateral for a bank loan; or one can speculate in securities that are owned outright, by buying with the intention of selling later on at a profit. There is more risk in poor judgment of selection than in the mere fact of carrying a security on margin. An inexperienced investor may lose more money on securities purchased outright than a skilled trader on margin.*

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As a matter of fact, there may be a distinct advantage in carrying some *investments* on margin, if money can be borrowed at a lower rate of interest than that received on the securities pledged. Suppose, for example, that you own 100 shares of a 7% preferred stock purchased at par (\$100), and that time money can be had at 6%: By putting up the stock with your bank for a loan of \$5,000, you would receive \$700 a year in dividends and pay \$300 as interest on the loan. Your equity of \$5,000 in the investment would thus yield a net income of \$400 per annum, or 8%. This profitable, and perfectly safe, method of gaining a higher yield is too often overlooked by investors.

### The Call Loan Market

When customers buy stocks and bonds on margin, it becomes necessary for their brokers to borrow part of the funds to settle in full with the sellers. The major portion of such borrowings are "on call," i.e., payable when the lender so demands, and can also be liquidated by the broker whenever he chooses. At present writing, time loans, which run for an agreed upon number of days or months, are in relatively small volume. This is because there is some doubt as to the legality of charging more than 6% for the use of funds loaned on time. Call loans in New York are however exempt from the usury laws, and may be made at any rate of interest upon which the borrower and lender agree.

The call money market in New York offers an opportunity for banks and other institutions, corporations and individuals throughout the country and, when rates rule at sufficiently high levels, throughout the world, for investment of surplus funds which

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would otherwise remain idle. In this sense, call loans constitute a secondary reserve for the banks.

The amount loaned by banks on stocks and bonds as collateral varies widely according to circumstances, in about the same manner as margin requirements discussed in the previous section. Some of the large brokerage houses make it a rule, however, to keep with their bankers securities valued at double the amount of the loan. Loans for the account of individuals, corporations, and out of town correspondents, are all arranged through New York banks, acting as agents, and a fee of one-half of 1% per annum on the amount of such loans is deducted by the banks for this service. New York banks will not loan a sum of less than \$100,000 for the account of any outside corporation or individual.

Except in special instances, banks do not make loans to brokers on a single issue. Their loan envelopes are composed at all times of a well assorted list of collateral. For the most part this consists of stable securities, with only here and there a volatile specialty thrown in. Each issue goes into the envelope at an "accepted value," which ranges all the way from full market price, in the instance of stable and unmanipulated stocks and bonds, down to perhaps as low as 40% of market price for pool favorites that have been moved up too rapidly. Then a flat 75% to 80% is advanced against the total amount. Good rails are generally accepted at only a few points under the market; whereas a stock like General Motors, at the time when it touched 210, was marked down by some banks to as low as 140. Call loans are thus protected by a quadruple line of defense: liberal equity in the collateral, the business honor and assets (including Stock Exchange seats) of brokers to whom the loans are made, the responsibility of the brokers' customers

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for whom the securities are being carried, and the close supervision exercised by the Stock Exchange over the business practices of its members. So far as is known, there has been only one isolated instance where a bank has sustained any loss on a Stock Exchange loan; whereas losses on other loans and discounts average about 3% to 4% of a bank's gross earnings. It can, in fact, be stated without exaggeration that brokers' loans are the safest of all investments.

With brokers' loans now amounting to over five billions, and an average daily turnover of from forty to fifty millions, it is evidently a practical necessity to have some central point at which these loan transactions can be carried out. A "money desk" is therefore maintained on the floor of the New York Stock Exchange, free of charge to its members. Early each morning, except Saturdays, the New York City banks notify the loan clerk at the money desk regarding the amount of funds they wish to loan on call (for themselves and correspondents) and the rate of interest they wish to obtain.

The opening rate for call money, which is also the renewal rate for loans that have been previously made but neither called nor repaid, is established each morning and announced on the stock tickers promptly at 10:40 by officials of the Stock Clearing Corporation, who gather at the money desk to fix the figure. In arriving at the renewal rate, consideration is given to the supply of money, the amount wanted, the previous day's rate, the market's activity, gold exports, and other money market influences. Having fixed the renewal rate, the clearing house officials have nothing further to do with call rates for the remainder of the day.

The day's call money market is thus formally

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opened. Let us say now that a broker wishes to borrow \$500,000 on Stock Exchange collateral. He goes to the money desk and, if the amount is on offer, makes arrangements with the official at that desk. The bank is then notified of the amount lent and to whom. The broker informs his cashier that the loan has been made. The bank gets written confirmation from the broker, and the broker receives written confirmation from the bank. Usually the loan is handled through the Stock Clearing Corporation, a subsidiary of the Exchange. The collateral is immediately assembled by the broker's cashier and sent to headquarters of the Stock Clearing Corporation, where small stalls are maintained for the loan clerks of each of the large banks. The collateral is examined by the bank's loan clerk and, if found satisfactory, the broker's messenger returns to his office with a check for \$500,000 from the Stock Clearing Corporation, which makes out its own check as a mutual accommodation to both broker and bank. The bank, in turn, promptly re-imburses the Stock Clearing Corporation for the sum paid out in its behalf. In the meantime, the broker has signed a note which binds him to repay the loan "on call," and to maintain an equitable margin between the market value of collateral and the sum loaned.

Loans are negotiated direct with certain banks which are not members of the Stock Clearing Corporation. In such instances a broker is faced with the seemingly insurmountable difficulty that a loan cannot be obtained without collateral, and the collateral (consisting of stocks and bonds purchased the day before for the account of customers, or tied up in loans that are called) cannot be obtained until the money is borrowed to pay for it. In practice, this impasse is surmounted by the following procedure:

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Each morning, before the opening, the broker anticipates his money requirements for the day by obtaining a so-called "overcertification" at banks with which he regularly deposits; signing notes for the corresponding amounts. The amount of the note is then credited to the broker's account and constitutes what is known as a "day loan," upon which the bank makes a nominal service charge at the rate of 1% per annum, regardless of whether all of the credit is actually checked out. Interest, at the prevailing rate for call loans, is charged only upon the amount of money actually advanced upon securities subsequently deposited as collateral.

If securities are not deposited as collateral, the day loan must be repaid the same day. The 1% service charge is obviated, wherever possible, however, by putting such transactions through the Stock Clearing Corporation, which makes out its own checks for the required funds, without charge to its members or those who clear through members.

Banks begin calling loans about 11:00 A.M. and may continue to 12:15. It is during this period that withdrawals are made as New York City banks find they require more funds for themselves or for their correspondent banks in out-of-town points who have made loans through the New York institutions. Some banks rarely call loans; others are prone to call loans when the rate rises after the opening, in order to re-loan at the higher rates. The latter practice is partly responsible for erratic fluctuations in call rates during periods of tight money. On the other hand, there is a bank with excess reserves to which it can always turn in emergencies, which has allowed one loan to run uncalled for the past 15 years. Not all call loans are made at the current rate. Between some of the larger banking institutions and best known brokerage

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houses there are agreements whereby a flat 6% is paid, regardless of fluctuations in the daily renewal rate; while in other cases the loans are made for as long as the borrower wishes to use the funds. On such continuing loans the rate fluctuates with the daily renewal rate.

Loans are repaid by a reverse process. The bank notifies the broker that his loan is called, and requests a check for the principal of the loan plus the interest for as many days as the loan has been maintained. Upon receipt of the check from the broker's messenger, his collateral is returned to the broker.

After all the money which is in supply at the money desk at the opening rate has been exhausted, loans are made from remaining funds which may be offered at varying rates. Obviously money for which the lowest rate is asked will be taken first, and then funds offered at the next highest rate, until all the morning's offerings by banking institutions have been absorbed. If the demand for money continues into the afternoon, then money brokers with funds of their own will offer money at the desk and, if the demand still continues, funds of stock brokers, private lenders, corporations, etc. In placing the afternoon loans, preference is always given to offerings by brokerage houses, followed by private banks and corporations. If supply still continues inadequate to meet the demand, some of the banks will then make additional offerings. Occasionally demand is overestimated, and at the close of the day the banks will find that they have made too large offerings. These will be carried over to the next morning, which usually brings about a lower renewal rate.

Time loans are not made at the money desk of the Stock Exchange; but are handled by a loan broker, who receives 1-32d of 1% for his services. Fre-

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quently the same broker handles the call money as well as the time money of one institution, handling the call money without commission in order to get the fee on the time money.

### Daily vs. Fortnightly Settlements

In view of the fact that probably 90% to 99% of outstanding call loans are renewed for the day at the opening rate for call money, it is evident that the wildly fluctuating afternoon rates which we experience during periods of stringency in the money market are due to calling of loans and shifting of funds, and apply only to a small portion of total loans outstanding. The importance of such erratic rates has therefore been greatly exaggerated. Nevertheless, because undue stress is laid upon them by many domestic and foreign commentators, which leads to so much unfavorable criticism of Wall Street methods and influences, it would be desirable to find some means of stabilizing our New York Call market.

Erratic fluctuations in interest rates, such as commonly occur in New York, are unknown abroad on account of foreign systems of periodic settlements. The London stock market, for example, trades for a settlement day at the middle and end of the month, making 24 settlements in the year, rather loosely called "fortnightly settlements, or accounts." This means that securities are delivered and paid for only twice a month. This system tends to stabilize interest rates; because Stock exchange loans thus become time loans, even if the time is short. In our sense, there is no call money market in London. The suggestion that we adopt at least a modified form of the London bi-monthly settlement plan, has always been met by

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dogged opposition from both the banks and the New York Stock Exchange.

The banks are opposed to the change: partly because of doubts as to the legality of time loans made at rates in excess of 6%; and partly because they are reluctant to convert extremely liquid call loans into what might be termed at least "semi-frozen" time loans. Banks who are not members of the Federal Reserve system still lean heavily upon call loans as a secondary reserve, since they lack the facilities of obtaining immediate cash by discounting commercial paper. The Stock Exchange opposes the innovation: partly because the banks object, and partly because the periodic settlements place a heavy strain upon brokerage firms during periods of money stringency, and make it more difficult at all times to force customers to keep their margins good between settlement dates. The business transacted by London brokers with their customers is upon a more intimate personal basis than in this country. In London, brokers are usually well acquainted with the financial responsibility of customers. In this country, owing to the constant state of flux in our population, it is practically impossible for a broker to become conversant with the financial resources of his numerous, and frequently transient, accounts. His chief means of judging a small customer's financial responsibility is the promptness with which the latter responds to margin calls, and the shrewdness he displays as a trader. E. H. H. Simmons, President of the New York Stock Exchange, is authority for the statement that foreign bankers and brokers who have studied our system of daily cash settlements, regard it as the most satisfactory method in the world for handling the problem, despite its obvious drawbacks.

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### Brokers' Loans

In October of the year we entered the War (1917) the Federal Reserve Board began to compile data on the amount of money loaned to brokers by New York banks, in order to determine whether credit that should be available for prosecuting the War was being absorbed by the Stock Market. It was not until ten years later, however, that a complete monthly résumé of these figures for the entire ten-year period was made available to the public. The information was believed to be so useful that, in February of 1926, it was incorporated with the regular weekly bank statements. The New York Stock Exchange decided about the same time to publish its own compilation of broker's loans. The latter statement, showing loans at the end of January, was first published on the 7th of February. Five days later the Federal Reserve figures were released, showing loans by weeks from the beginning of 1926. It will be recalled that the psychological effect of publishing these huge totals precipitated a sharp break in the stock market. That people then should have become almost panic stricken upon learning that brokers' loans were about three *billion dollars* seems a little humorous in view of the unprecedented bull market that was raging three years later on loans of *over five billions!* In the interval, we have had repeated warnings of pending disaster, emanating from high authority, with each quarter billion increase in the totals. In October of 1917 brokers' loans were somewhat *under a billion dollars!* When we come to discuss the subject further in Chapter V, the part played by "loans for others" will be analyzed at some length. In the meantime it is worth noting that loans by New York City member banks for their own account averaged 688

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millions in October of 1917, and were only 200 millions greater in October of 1928; whereas loans for the account of correspondents, made by New York City member banks, had mounted during the twelve-year period from the insignificant figure of 240 millions to the huge total of 3,740 millions!

Figures reported by the New York Stock Exchange show the amount which members in New York City have borrowed on stock and bond collateral from all sources, on the last business day of each month. The report is made public a few days later. The statement issued by the Federal Reserve Board is released from Washington every Thursday, at about 4 P.M. These figures are part of the general weekly bank statement, and show loans made only through New York City member banks, outstanding at the close of business on Wednesday (the day before). But inasmuch as Stock Exchange transactions are not cleared until the following day, the totals thus reported reflect security purchases for the week ended Tuesday on the Exchange. The brokers' loan statement published by the Federal Reserve Board consists of four items:—total loans, loans made by New York City member banks for their own account, loans made for the account of out-of-town banks, and loans made for the account of "others" (corporations, individuals, foreign banks, etc.) The Stock Exchange report shows total loans; net borrowings on collateral from New York City banks and trust companies; and net borrowings on collateral from private bankers, brokers, foreign bank agencies, or others in New York City. Loans carried outside of New York City are omitted from both statements. There is thus generally a discrepancy between the monthly report issued by the Stock Exchange and the weekly Federal Reserve report. This is partly because the two reports

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do not include exactly the same sources, and partly because they rarely cover the same day. With publication of the Stock Exchange's initial report, in February of 1926, there was included the following statement: "Of the total loans reported, approximately one-third was borrowed through out-of-town branches and correspondent offices. This third, however, does not include a large aggregate of loans contracted for out-of-town customers who deal through New York offices directly, rather than through their branches and correspondents in other parts of the country."

At the end of January, 1926, brokers' loans reported by the Stock Exchange were only 418 million dollars greater than the total amount reported by the Federal Reserve Board. By the end of May, 1929, this spread had grown to 1,377 millions, owing to the rapid increase in offerings through non-member bank channels. It is generally conceded that the Stock Exchange figures are more complete than those reported by the Federal Reserve Board; but the latter are of more general interest on account of the greater frequency with which they are issued.

Of recent months, the Stock Exchange has also begun to publish the percentage ratio of brokers' loans to the aggregate market value of listed stocks. This is an index which, in time, may prove to be of considerable barometric value as a clue to the "technical position" of the stock market.

### The Bank Statement

The weekly bank statement, showing the condition of Reserve and member banks at the close of business on Wednesday, is published in two sections. Statements of condition for each of the twelve Federal Reserve Banks and a combined statement for all

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twelve, together with a combined report for New York City member banks, appears in the Thursday morning newspapers. The combined statement for all reporting member banks throughout the country is published in daily papers the following Tuesday morning. The delay in this instance is due to the time and labor required to transmit and summarize such a large number of separate reports. In addition to these weekly statements the Federal Reserve Board compiles several times a year, and publishes in the Federal Reserve Bulletin, a combined statement for all banks and trust companies in the United States, including non-member, private and savings banks. This covers only a few of the most important items; such as loans, deposits, and investments. More detailed combined statements are incorporated in the annual reports of the Comptroller of the Currency.

The importance of various bank statements, and the relative position occupied by the Federal Reserve System in the world's banking activities and those of our own country, may be gleaned from the following data:

TABLE I  
BANK DEPOSITS and MONETARY GOLD STOCKS—End of 1926  
(Billions)

	Individual Deposits	Monetary Gold
United States .....	52	4.08
Other countries .....	32	5.08
World total .....	84	9.16

TABLE II  
DISTRIBUTION OF MONETARY GOLD STOCKS IN THE UNITED STATES—  
June 30, 1928  
(Millions)

Federal Reserve banks.....	2,583
All other banks.....	73
U. S. Treasury.....	130
x-In circulation .....	1,323
Total .....	4,109

x-Including gold certificates

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TABLE III  
CONDENSED BANKING STATISTICS OF THE UNITED STATES, EXCLUSIVE OF  
FEDERAL RESERVE BANKS—June 30, 1928  
(Billions)

	y-All Banks	Member Banks	% to all Banks	% to all-x Banks, ex- cept-x Mu- tual Sav- ings and Private	Mu- tual Sav- ings Banks	Pri- vate Banks
Number of banks.....	26,145	8,929	34.19	35.57	616	404
Loans and discounts.....	39.41	24.74	62.77	73.17	5.51	0.09
Investments .....	18.73	10.76	57.44	71.96	3.75	0.03
Cash .....	0.87	0.45	51.91	54.03	0.03	.....
Capital .....	3.49	2.42	69.11	69.28	.....	0.01
Surplus and undivided profits	5.35	3.21	59.99	73.95	1.00	0.01
Individual deposits .....	53.02	31.05	58.55	70.18	8.67	0.11
Aggregate resources .....	71.23	45.09	63.31	73.45	9.69	0.15

x-Private and mutual savings banks are not eligible for membership in the Federal Reserve system.

y-Includes private and mutual savings banks.

The weekly combined statement of reporting member banks in leading cities includes banks whose aggregate resources are about 65% of the resources of all member banks, and thus conveys a fairly reliable picture of changes that are taking place within the entire membership.

## CHAPTER II

### The New Status of the Common Stock

THE present wave of popular interest in the stock market is not *per se* a very new phenomenon, but it possesses several characteristics which have reached such an advanced stage in the evolutionary path of their development that a new social and economic order may soon emerge if present tendencies continue to spread at the accelerated rate witnessed during the past few years. When water rises in temperature from 60 to 200 degrees the change is only in degree, not in kind; but if the trend continues only 12 degrees further it results in conditions which are actually new in kind. The water is changed into steam.

The two most significant aspects of the present bull market are, perhaps, the growing recognition of the value of common stocks as investments, and the rapid diffusion of ownership among people of moderate means. The advantages of including a suitable proportion of well selected common stocks in the investment portfolio have been emphasized by THE MAGAZINE OF WALL STREET for the past twenty-two years. At the outset, its voice was one crying almost alone in the wilderness. Now everyone has taken up the slogan, "Common stocks for investment," and the pendulum has swung so far that some day there is bound to come a regrettable reaction in sentiment, due to the fact that many inexperienced investors are overlook-

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ing the precautionary qualifications, "*a suitable proportion of well selected common stocks.*"

### Growing Importance of the Common Stock

On the 27th day of March, 1929, 8,246,740 shares of stock changed hands on the floor of the New York Stock Exchange. It was the heaviest five-hour session that history had recorded since Wall Street began trading in securities under the famed Buttonwood tree, during the closing years of the eighteenth century. Antiquarians thumbed the musty records and it was discovered that ninety-nine years ago, on March 16, 1830, the day's transactions had amounted to just 31 shares! The contrast affords striking evidence of the tremendous rise in public participation in the stock market during the past century; but fails to convey an adequate conception of the accelerated pace at which this economic revolution has been proceeding. A glimpse of this change in tempo is afforded by the sequence of new high records in annual sales of stock on the "Big Board" during the past half century, presented in Table I.

TABLE I  
FIFTY YEARS OF NEW HIGH RECORDS IN STOCK TRANSACTIONS  
ON THE "BIG BOARD"

Year	Annual Transactions (Million shares)
1882.....	116
1899.....	179
1901.....	265
1919.....	320
1925.....	464
1927.....	569
1928.....	922

Table I shows that it was 37 years before the new high record attained in 1882 was trebled by the new high record of 1919; whereas the 1919 record was in

## The New Status of the Common Stock

its turn trebled within the brief span of ten years.

Changes in the character of transactions on the Stock Exchange since the opening of the twentieth century have been even more startling than the growth in volume of sales, as will be noted from inspection of data in Table II.

TABLE II

SIGNIFICANT EVOLUTIONARY CHANGES IN THE STOCK MARKET

	1901	1928	% Increase
<i>Shares Listed</i>			
Rails .....	31,696,100	63,736,700	101
Utilities .....	8,858,800	75,692,700	755
Industrials .....	20,936,500	545,367,700	2,460
Total .....	61,491,400	684,797,100	1,013
Year's sales .....	265,266,687	922,062,900	248
% Rails .....	x-75.0	5.7	
Annual turnover .....	4.32	1.35	

x-1902.

The great bull market of 1928 is thus seen to have differed greatly in character from the one in 1901 and 1902. During the former period, railroad stocks constituted 50% of the shares listed, and transactions in the rails attained the huge proportion of 75% of total sales. The market of 1928 was all but monopolized by industrial and public utility issues.

Bull markets of the past have always stimulated public interest in common stocks; but the interest has hitherto been largely speculative. There was a good deal of in-and-out margin trading in 1928; but out-right purchases by investors undoubtedly accounted for a far greater proportion of total transactions than in any previous bull market. This fundamental change in the public's attitude toward common stocks becomes apparent in the sharp drop in annual turnover for 1928 as compared with 1901, and is further evidenced by the phenomenal rate at which recent new

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issues of securities have been absorbed. In fact, during the 5½-year period from the beginning of 1924 to date, new listings of securities on the New York Stock Exchange reached the huge total of 23 billions of dollars, yet the accompanying increase in brokers' loans amounted to less than 6 billions.

### Diffusion of Ownership

Before the War, common stock investments were looked upon as a luxury for the rich. Few financial writers outside the columns of *THE MAGAZINE OF WALL STREET* had the courage to advise folks of ordinary means to risk their savings in common stocks. At times the public speculated wildly in stocks; but bought bonds for investment. Stocks were generally regarded as too risky for the average individual to buy and keep. But since the War a number of influences have contributed to a marked reversal in this attitude. The growing spread between earned incomes and the cost of life's necessities has enabled people to save more; Federal Reserve policies have tended to stabilize conditions so that business depressions and reactions in the stock market are no longer so severe as they used to be; facilities for disseminating financial news and placing orders in the stock market have been greatly expanded; the habit of investing has been inoculated by widely distributed popular subscriptions to our Liberty bond issues; and great progress has been made in educating the public to discriminate between stocks which possess attractive long pull investment possibilities and those which should be regarded as only speculative. A glimpse of this rapid extension of investment facilities is given in Table III.

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TABLE III  
SIX YEARS OF GROWTH IN PUBLIC FACILITIES FOR INVESTING  
IN COMMON STOCKS

	End of		% In-
	1922	1928	crease
No. of financial news tickers in U. S. (Estimated index number) .....	100	316	216
Paid circulation of THE MAGAZINE OF WALL STREET .....	35,511	98,972	179
No. of Western Union N. Y. S. E. Stock tickers in U. S. ....	3,000	6,100	103
No. of New York Quotation Co. N. Y. S. E. Stock quotation tickers in New York City....	1,500	2,230	49
Individual deposits, about June 30, in all banks in the U. S. (millions).....	37,194	53,245	43

The growth of popular interest in the modern science of investing, as depicted in Table III, offers encouragement to sociologists who look forward hopefully to the time when all the people of the United States will become partners, through stock ownership, in the country's business. That the goal is still far from having been attained may be inferred from the current circulation of THE MAGAZINE OF WALL STREET which, though greater than that of any other financial publication of its kind in the world, is still considerably below that of our large metropolitan newspapers. On the other hand, the circulation figures tend to cast considerable doubt upon the frequently quoted statement that there are now upwards of 15,000,000 corporation stockholders in the United States. A more credible estimate is that prepared by Joseph S. McCoy, Actuary of the U. S. Treasury, which places the number of individual stockholders at 2,358,000 in 1924, after eliminating duplication of holdings. The figure is derived from an analysis of income and inheritance tax returns. A five-year increase of 70% in this figure would be in keeping with developments recorded in Table III and yield an estimate of 4,000,000 as the number of separate individual stockholders for the year 1929.

According to Table IV, the number of stockholders

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in thirteen leading corporations has increased by 122% during the past ten years. Since the pace of all financial tendencies is known to have been considerably more rapid during the second half of the decade it appears reasonable to infer from these data also that the growth in stockholders since 1924 amounted to about 70%. We are therefore inclined to believe that 4,000,000 is a fairly close estimate of the present number of individual stockholders in the United States; but the whole subject is soon likely to assume such great importance that accurate data should be gathered through the census.

TABLE IV  
NUMBER OF STOCKHOLDERS IN 13 LEADING CORPORATIONS

Company	1918	1928
American Smelting & Refining.....	4,006	4,474
American Tel. & Tel.....	51,689	96,558
Atchison, Topeka & Santa Fe.....	28,669	37,734
General Motors (all classes).....	2,920	66,209
National Lead Company.....	1,810	2,081
Pennsylvania Railroad .....	103,003	143,249
Southern Pacific .....	37,088	58,117
Union Pacific (all classes).....	37,131	49,096
United Gas Improvement.....	12,334	16,318
United Fruit .....	9,653	25,549
United States Steel.....	51,689	96,558
Western Union .....	22,663	25,380
Westinghouse Mfg. ....	20,077	34,007
Totals .....	443,463	982,352
Ten-year increase .....		122%

### Employee Ownership

Of the 4,000,000 individual stockholders in the country at this time, it seems probable that at least 25% are employee owners. This is a tendency which has gained great headway since the War. From an analysis of data submitted by 315 corporations having a total of 2,736,000 employees, including executives and department heads, the National Industrial Conference Board found in 1927 that about 800,000

## The New Status of the Common Stock

employees were making payments on company stock with an aggregate market value of more than a billion dollars.

### Women Stockholders

The rapid rise of women in the field of investment and finance has been one of the outstanding developments of the past decade. At present writing it is estimated that they constitute at least 25% of the 4,000,000 individual stockholders of this country. In some of our most prominent corporations the percentage is much higher, as will be seen from Table V.

TABLE V  
PROPORTION OF WOMEN STOCKHOLDERS IN 10 LEADING CORPORATIONS  
(About June 30, 1927)

Company	%
American Tel. & Tel.....	54.0
American Sugar Refining.....	47.0
General Electric.....	47.0
National Biscuit.....	50.0
Norfolk & Western.....	48.0
Pennsylvania.....	50.4
Pullman.....	46.0
Southern Pacific.....	45.5
United States Steel.....	37.4
Westinghouse Air Brake.....	52.0

Women are said to be beneficiaries of 80% of life insurance policies in force in the U. S. They are receiving 70% of the estates left by men, and 64% of those left by other women. Women millionaires are as plentiful as men, according to income tax returns, and pay over 40% of the total individual income tax. Leading bond houses say that 35% to 40% of their customers are women. One ardent feminist figures that by the year 2,025, women will own the entire wealth of the country; but it is not wise to extrapolate too far in forecasting from current tendencies. So far as the present era is concerned, we now find women's departments in many of the

## How to Secure Continuous Security Profits

large banking and brokerage houses, staffed by women; and it is significant of the times that the head of the world's most widely read financial publication is today a woman.

### Ascendency of the Common Stock

The year 1928 witnessed one of the greatest bull markets in common stocks that has ever been known in Wall Street history. Influences outlined elsewhere in these pages, accompanied by rising interest rates and phenomenal increases in earnings and numerous large scale consolidations, created an almost insatiable demand for common stocks in preference to bonds. This development, which is shown in Table VI, has been a feature of previous bull markets, but probably not to the extent witnessed during the past few years.

TABLE VI  
THE GROWING PROPORTION OF STOCK ISSUES TO NEW SECURITIES OFFERED

Year	New Capital (Millions)	% Stock
1921	3,307	8.1
1922	4,304	13.3
1923	3,645	15.3
1924	5,593	14.8
1925	6,220	19.5
1926	6,344	18.6
1927	7,776	19.2
1st half 1928	4,134	28.8
2d half 1928	3,916	46.4
1st half 1929	3,827	45.3

The great facility with which common stocks could be marketed during the past few years has enabled many large corporations to retire a large part, if not all, of their senior securities, leaving the common stock as the sole equity. This places such companies in strong position to meet future depressions in business, and adds much to the stability of their common stocks as investments. When interest rates ease off again and become stabilized at lower levels we shall

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undoubtedly witness a revival in the bond market, and a proportionate decline in the demand for common stocks; but the advantages of long term investment in the common stocks of *growing* companies have become so widely understood that bear markets of the future are not likely to obliterate the lesson entirely.

We can not close this chapter without a word of caution that not all common stocks are attractive, or even safe, as long pull investments. It is only the stocks of well managed and growing companies that one should buy to keep. The majority of common stocks are more or less speculative, and are attractive at certain periods of their market careers, but unsafe at other times. The investor who handles common stocks must exercise great care in deciding what and when to buy, and must ever be on watch for the best time to close out the more speculative of his holdings.



## CHAPTER III

### Market Prices versus Values

#### Is the Market too High?

**D**EBATE over this enigma is as old as the history of Wall Street, yet never has the answer been of such vital interest to so many or to such a great variety of people; because never before have stocks reached such heights or been so widely distributed. If all participants in the present heated discussion viewed the problem from the same angle, it might be possible to apply a common measure of values and arrive at something approaching a unanimous conclusion; but the moralists use one yardstick, the banking authorities another, economists a still different one, traders a fourth, and investors a fifth—not to mention certain politicians who evince little interest in undramatic facts. It may help though to crystalize opinion if some rational means can be established for valuing common stocks on an investment basis, and it is to this task that the present and following chapter are devoted.

The investor would like to know if it will pay him to buy stocks at present levels for the long pull. From this viewpoint it is difficult to say whether the market at any time is too high or not. The average person must confine his commitments to a comparatively small number of issues: he can not buy the whole list. In almost any market there will be some stocks which are overpriced, and others which will

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increase their dividends and sell higher in years to come and so must be currently underpriced as investments. The investor's problem is to select issues which are underpriced from the long range viewpoint, and to avoid those which are destined to work lower ultimately. It is sometimes desirable, though not essential, to wait for a reaction before buying; but reactions, and even primary bear markets, are not so important to the investor as to the trader.

The trader is obliged to take reactions and bear markets into the reckoning; because nearly all stocks—good and bad—decline at such times, and it is little consolation for a trader faced with a paper loss to be told that his stock will sell higher a few years hence. What he plans is to profit by relatively nearby price movements that arise frequently from causes, such as news developments and passing disturbances in the money market, which bear little relation to changes in intrinsic values.

It can not be too strongly emphasized that, though the trader must learn *when* to buy, the investor should concern himself chiefly with *what*. Good stocks can be bought to advantage at any time; for, *in the long run, competition among investment media invariably causes stocks and bonds to sell as close to their intrinsic values as known facts and the supply of credit will permit.*

The outstanding difficulty in judging whether or not stocks are selling too high on an investment basis is to decide upon a common standard by which values may be measured. The three methods in common use are known as: the "Yield" basis, the "Times Earnings" ratio, and "Discounting the future." If correctly applied, all three of these methods, as will be seen later, bring identical results; but analyses founded upon a superficial understanding of the prin-

## Market Prices versus Values

ciples involved frequently lead to startling discrepancies and uncertainties.

### The "Yield" Method

This method, which is the oldest of all devices for sifting out attractive investments, was originally applied to preferred stocks and then expanded gradually to include common stocks. It served as a fair guide, perhaps, in the days when income was the chief concern of investors; but in the inflationary post-War period through which we have been passing, spectacular increases in common stock prices have been so numerous that opportunity for enhancement of principal has largely supplanted dividends as a lure to investors.

And so it happens that, for the time being at least, "Yields" are out of fashion and "Times earnings ratios" are all the rage as rough and ready measures of common stock values. At some later date, when and if economic and financial conditions become more stabilized, "Yields" might again become popular, and so the method is here described for its possible future, as well as its historic, interest.

The procedure is to arrange a list of stocks—preferably, though not necessarily, of the same industry—in order of descending yield, as in Table I. Since "Yield" is here defined as the percentage ratio of current annual dividend to current market price, it is obvious that one can obtain the biggest income for his money by investing in stocks near the head of the list, and that issues near the bottom should be least attractive—all other considerations being equal. Railroad stocks have been chosen here to illustrate the method, because these are more likely than issues of other industries to sell on a yield basis. The reasons

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TABLE I  
Railroad Stock Yields

Railroad	1927		1928	
	Market Price	Current Annual Div. Yield	Market Price 12-31-27	Current Div. Yield
Chesapeake & Ohio.....	162½	12.00	126½	4.93
Pere Marquette.....	114	8.00	126½	6.32
St. Louis San Francisco.....	102	7.00	109¾	7.29
Bangor & Aroostook.....	45¾	3.00	69	84
Northern Pacific.....	78½	5.00	97½	5.07
Norfolk & Western.....	158½	10.00	190	5.12
Great Northern Pfd.....	180¾	5.00	197½	5.26
Union Pacific.....	162½	10.00	191¾	5.13
Pennsylvania R. R.....	56½	3.50	64½	5.22
Baltimore & Ohio.....	108	6.50	117½	5.42
Canadian Pacific.....	167½	10.00	177½	5.12
N. Y., Chic. & St. L.....	190	11.00	208¾	6.00
Illinois Central.....	122½	7.00	135¾	10.00
New Orleans, Tex. & Mex.....	122½	7.00	132½	6.00
Southern Ry.....	126¾	7.00	137	7.00
Southern Pacific.....	110½	6.00	148¾	5.11
Louisville & Nashville.....	129	7.00	155	6.00
Reading Co.....	96	5.00	104	8.84
Delaware & Hudson.....	173¾	9.00	182½	4.51
Alabama & Vicksburg.....	117½	6.00	125	5.00
Lehigh Valley.....	100	5.00	93¾	9.00
N. Y. Central.....	143¾	7.00	163	3.75
Atlantic Coast Lines.....	205½	10.00	185	4.90
Del., Lack. & Western.....	145	7.00	137½	10.00
Buff., Roch. & Pitts.....	85	4.00	70	5.41
Pitts. & West Virginia.....	135½	6.00	146	7.00
Nashville, Chat. & St. L.....	160	7.00	186	5.72
Central R. of N. J.....	290	12.00	310	4.11
Atchison, Top. & Santa Fe.....	170¾	7.00	193¾	6.00
N. Y., Ont. & Western.....	24¾	1.00	31	7.00
Colorado Southern.....	84	3.00	115	3.22
C., C. & St. L.....	273	7.00	292	3.00
Average yield.....		5.37		8.00
Time money—December.....		4.82		2.74
		4.69		3.15

## Market Prices versus Values

for this are discussed at some length in *The New Technique of Uncovering Security Bargains*, published by THE MAGAZINE OF WALL STREET.

A close study of Table I will show why *the Yield method, unsupported by other data, is no longer regarded as a satisfactory guide for selecting investments*. In fact it violates one of the cardinal principles of investment that *high yields are a warning signal*, and is of little value to the modern investor who looks more to growth in principal than immediate cash income. If the method means anything, the three stocks which head the list ought surely to have been a better purchase on January 1st, 1927, than the three issues at the bottom; yet one of the three high-yield stocks reduced its dividend the following year by an amount which was not offset by the dividend increase of another issue. Among the three low-yield stocks there was also one increase in dividend, but no decreases. Moreover, if a person had invested an equal sum of money in each of the three low-yield stocks his principal would have increased 21.7% within a year; whereas a like investment in the three issues that head the list would have grown only 14.5%. Another serious objection to the yield method is that it leaves non-dividend paying issues out of consideration altogether; for, since the yield of all such is zero, there is no means of distinguishing one from another.

Before leaving the Table, it is interesting to note how the yield of railroad stocks as a group tends to move in unison with changes in time money rates. At the end of December, 1926, there was in fact practically the same spread between 90-day time money and the average yield of 32 railroad issues as existed at the end of December, 1927. This merely serves as an illustration of the well known rule that *stocks*

## How to Secure Continuous Security Profits

*of investment calibre tend to move inversely with interest rates.*

### The "Times Earnings Ratio"

Some shortcomings of the yield method may be overcome by expressing a stock's market price as a ratio to its per share earnings, thereby eliminating the disturbing factor of varying dividend policies. The times-earnings ratio is an ideal measure of common stock market prices; since it reduces all issues to a comparable basis, regardless of actual market price or the number of shares outstanding, and independent of actual earnings per share, or the proportion of such earnings which is disbursed as dividends. Unfortunately it is not so directly applicable in situations where per-share earnings are small, or "in the red." When applying this ratio to stocks whose per-share earnings have been decreasing moderately, however, it is generally advisable to use the larger per-share earnings of the two most recent years, especially in a bull market; because investors usually take the attitude that a single year's decline in earnings was merely accidental, and that true earning power is at least equal to that shown the year before.

### The Out-of-Line Method

For each industry there is an average times-earnings ratio for which stocks sell at any given time. Whenever an individual issue within the group shows a times-earnings ratio conspicuously higher or lower than the average, it is well for the investor to ascertain the reason why.

An exceptionally low ratio may indicate that the Company's affairs are on the down grade, it may mean

## Market Prices versus Values

that conditions are now changing for the better after a period of dubious outlook, it may turn out to be a situation in which earnings are increasing more rapidly than the market has been able to discount, or it might be one of those rare opportunities that have been unaccountably neglected by investors.

A conspicuously high ratio may indeed indicate that the stock has, for the time being at least, over-discounted the future; but it may also point to the likelihood of larger earnings to come.

There are several other characteristics of this ratio to which weight should be given when using the method to select investment opportunities.

1. The times-earnings ratio almost always moves with the general market and, in the instance of speculative favorites, may move further in either direction than the combined average; because stocks of a speculative character usually overdiscount the future.

2. There are usually issues in any group which sell persistently, from one year to another, on a higher or lower times-earnings basis than other issues in the same group. This may be due to differences in the rates at which earnings are changing, to differences in the amount of publicity accorded to various issues, to differences in their appeal to the popular imagination, or perhaps to hidden assets and concealed earning power.

3. Stocks of stable and growing industries usually sell on a higher average times-earnings basis than those of an industry which is subject to periodic depressions.

4. A stock whose times-earnings ratio is conspicuously lower than the average for its group, will be much more responsive to an upward movement in the general market than to a downward movement; and a stock whose times-earnings ratio is conspicu-

## How to Secure Continuous Security Profits

ously higher than the average for its group, will usually be more responsive to a downward movement in the combined averages than to an upward movement.

*Consequently the most profitable stock of a given group to buy is usually that one which shows the lowest times-earnings ratio, at a time when prospects point to rising earnings for the Company, improved outlook for the industry, and a probable advance in the combined averages. Diametrically opposite conditions would point to the most dangerous stocks to buy.*

Data for testing the practical value of the out-of-line method of selecting investment opportunities are presented in Table II.

Readers who are already familiar with the out-of-line method should note the innovation, employed in Table II, of basing the times-earnings ratio on the higher earnings of the two most recent years.

It will be observed that, as a general rule, issues which began a year with low times-earnings ratios ended the year with the largest price advances; while those with a high ratio declined in price, or at least rose very little. The only exceptions were U. S. Steel, in 1927, which rose considerably in response to the increase in dividend effected by its 40% stock dividend; and Ludlum Steel which despite its high times-earnings ratio, advanced violently in 1928, in response to a phenomenal increase in earnings.

## Discounting the Future

One of the strangest fictions ever promulgated by Wall Street apologists is the contention that market prices infallibly discount the future: that the collective judgment of all who buy and sell is endowed with

# Market Prices versus Values

TABLE II  
Out-of-Line Data for Nine Steel Stocks

Stock	Earned per Share		1926 Closing Price	Price Times Earnings	Earned per Share		1927 Closing Price	Price Times Earnings	Earned per Share		1928 Closing Price	Price Times Earnings
	1925	1926			1926	1927			1927	1928		
Beth. Stl. ....	5.30	7.48	47	6.3	7.48	5.02	58	7.8	5.02	6.52	88	13.3
Colo. Fuel .....	4.65	7.60	43	5.7	7.60	7.10	78	10.3	7.10	2.50	70	9.9
Crucible .....	7.19	8.72	81	9.3	8.72	7.03	90	10.3	7.03	7.07	89	12.6
Gulf States .....	7.17	5.27	54	7.5	5.27	4.92	53	10.0	4.92	6.28	68	10.8
Ludlum .....	2.97	2.11	27	9.1	2.11	1.67	27	12.8	1.67	4.34	77	17.8
Otis .....	1.06	2.03	8	3.9	2.03	0.75	11	5.4	0.75	3.16	37	11.7
Republic .....	6.88	11.05	58	5.2	11.05	2.12	60	5.4	2.12	4.19	86	20.5
U. S. Stl. (New) .....	9.20	12.84	112	8.7	12.84	8.80	152	11.8	8.80	12.50	151	12.1
Youngtown .....	12.38	14.32	88	6.1	14.32	6.10	97	6.8	6.10	9.54	114	11.9
Average .....				6.87				8.96				13.40
M. of W. St.—Combined Average.....				95.7				116.3				165.4

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an omniscience not possessed by the individual investor. A moment's reflection will show that a stock can have only one intrinsic value at a given time; and that investment values, which are determined by future dividends and interest rates, could not possibly fluctuate so rapidly, or erratically, as do actual market prices.

Market value is one thing; intrinsic value or worth is another. If a stock is worth intrinsically 100 today, it cannot be worth intrinsically 200 a year from now: still less could it be worth 105 tomorrow and 95 next week. Yet even greater inconsistencies in market movements are matters of common observation. In point of fact, it is only in exceptional instances that a stock happens to sell for its true value: usually it is either overpriced or underpriced.

The whole theory of modern investment technique is founded upon the search for securities which are now underpriced, but destined to sell later for at least what they are worth. At first thought it seems incredible that bargains of any consequence could exist in a free open market whose wares are accorded the maximum of advertising, and upon which the earnest attention of investors throughout the civilized world is continually fixed. Yet there never has been a time, and probably never will be, when the market was bare of stocks that were not only moderately, but greatly, underpriced. There are several reasons for this.

1. *The true investment value of a security is the present worth of all future benefits to its holders.* Hence one reason why intrinsic values can never be computed accurately is because this would call for infinite foresight.

2. Even with complete knowledge of the future it would still be impossible to find a common value

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upon which everyone would agree; because investors have different requirements, and these vary from time to time. Some are satisfied with enhancement of principal, others want cash income; some demand a current yield of 8%, others are content with 4%; some value a stock for its voting power, others will not even bother to sign a proxy; some buy for purely sentimental reasons, others are influenced only by cold facts; some are forced to liquidate for need of ready cash, while others buy because they can think of no other use for superfluous funds.

3. Security prices are determined by the same laws of supply and demand that apply to other commodities. When more shares are offered at a given time than are wanted, the price will decline; and *vice versa*. Market prices of a day, or week, are thus made by the turnover of a relatively small portion of the total number of shares outstanding. When unfavorable news, manipulation, or forced liquidation brings an excessive supply into the market, prices may fall considerably below true values and remain there until the more leisurely demand from investors, and through pool accumulation, absorbs the increased floating supply.

4. Manipulation and the activities of professional traders, who have an eye more to market profits than investment values, sometimes account for the spread between market prices and true values; though not so frequently now that financial reports and industrial statistics are available to all, as in the days when false rumors thrived on the concealment or withholding of facts.

5. Investors who can look farthest into the future, and who possess the greatest ability to interpret their vision in terms of values, will usually be among the first to recognize real bargains; but their purchases

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are seldom in sufficient volume to cause much of a rise in price. Eventually, however, shrewd buying of this character will reduce the floating supply to a point where the stock becomes attractive to some pool with advance information of pending favorable developments, and its manipulative efforts will accelerate the process of adjusting market prices to true value. Stocks seldom rise of their own accord: they have to be put up by concentrated and, usually, organized buying.

6. Stocks, like other commodities, require advertising in proportion as they lack in appeal to the popular imagination. Bankers, brokers, advisory services, and financial publications, sometimes have to recommend a real investment opportunity over and over again before the interest of investors is sufficiently aroused to pull a dormant stock up out of the bargain class. On the other hand, something spectacular in the day's news may start a tremendous buying wave in the issues of such new industries as radio, aviation, or the talkies.

7. Sometimes favorable developments which have been known to insiders, and publicly predicted by market writers and analysts, far in advance, will fail to arouse the great army of outsiders until the long anticipated news is officially announced.

8. Values predicated upon information available to even the most foresighted of forecasters may be altered radically by new developments which could not possibly have been foreseen. The most privileged of insiders will sometimes miscalculate.

9. There are fads, too, in methods of appraising security values. Once stocks were measured by current yield: now analysts favor the times-earnings ratio: in years to come some other method may come into vogue. Different methods may point to different

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values, and this exerts a certain amount of influence upon the opinions of investors. In the long run, however, no method of estimating intrinsic values can survive which fails to meet the practical test of predicting long range market movements.

10. In times of credit stringency prices fall below the line of intrinsic value. After a long period of easy credit conditions, the prices of many stocks are likely to rise above their true worth as long pull investments. This is because people either lack the money or are afraid to buy when prices are near bottom ; but catch the speculative fever and find it comparatively easy to obtain money during the later stages of a prolonged bull market.



## CHAPTER IV

### Valuing the Common Stock on a New Basis

THE Out-of-line method of discovering stocks that are overpriced or underpriced is of considerable practical value in many instances, but possesses two serious drawbacks: it fails to show *how much* a stock is over or under priced, and can be used only to compare stocks within the same industry. It was with the object of overcoming these defects that the writer has developed the quantitative method of computing intrinsic values described in the present chapter. The underlying principle is an adaptation of the definition of investment value proposed in Chapter III.

#### Intrinsic Value

If an investor had the gift of looking into the future and knowing the exact dates and amounts of every disbursement on a stock, together with all fluctuations in the rental value of money, from now until the end of time, it would be a comparatively easy problem in compound interest to determine the price at which the stock should sell in order to yield a desired return upon the investment. To such a person a stock's investment (i.e., intrinsic) value would be the present worth of all future disbursements, at varying rates for money, from now until the end of time. This would be the method of appraisal employed by the average investor whose sole interest in a stock is simply the rate of return upon his prin-

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cial; provided there be included in the return, not only dividends but appreciation in market price.

At first thought it seems rather visionary to predicate values upon the unknowable future; yet this is what the stock market is continually striving to do. In place of perfect knowledge of coming developments, however, people substitute estimates based upon current projects and past achievements. There is indeed, as we shall see later, a marked tendency in practice for the market to value stocks on the simple assumption that past performances will be reduplicated interminably in the future. If earnings and dividends have been irregular for a number of years in the past, the market tends to value a stock on the assumption that a like irregularity will continue in the future; if dividends have been at a uniform rate in the past, it is presumed that they will continue to be paid at the same rate indefinitely; and if earnings have been increasing steadily for several years, the market tends to value the stock on the theory that earnings will continue to increase at the same rate forever.

The new method of estimating intrinsic values here presented, merely reduces to mathematical form this process of projecting the past into the future. It shows what a stock would be worth as a long term investment if recent tendencies were continued forever, and thus offers a definite standard by which to judge whether a stock is over or under priced. According to this plan, the process of weighing a stock's attractiveness as a long pull investment would naturally divide itself into three stages:

1. In the light of past performances and current prospects, what developments in the matter of earnings and dividends may be reasonably expected in the future?

## Valuing the Common Stock on a New Basis

2. If future earnings and dividends should be as expected, what would the stock be worth now as a long pull investment?

3. Compared with its supposed value, as thus determined, how much is the stock now under or over priced?

Short term notes are the simplest of all investments to evaluate. For example: with money worth 6%, what is the value of a six-months note for \$1,000, bearing interest at the rate of 5% per annum? Obviously its intrinsic value is the present worth of the principal plus the present worth of the interest. This is \$1,000 divided by 1.03 plus \$25 divided by 1.03: namely \$970.87 plus \$24.27, or \$995.14. The proof is that, after six months, you will get back \$1,025 for an investment that cost \$995.14. The difference, \$29.86, is 3% on your six-months' investment, which is at the rate of 6% per annum. It should be observed at this point that the return of \$29.86 is composed of \$25.00 in interest and \$4.86 in appreciation of principal. Had the note been for two years, with interest payable semi-annually, the method of computing its investment value would have been the same, though complicated by compound interest.

Preferred stocks are the next easiest to evaluate, and then come bonds and common stocks; but the same general principle is applicable to all types of investments. Let us say, then, that *Intrinsic Value is the present worth of all future cash receipts from an investment*, and see where the definition leads us. We have just used the method to find the investment value of short term notes, and all the text books employ it in computing bond yields. So far as we know, though, the first application of the formula to evaluate common stocks was outlined in Chapter XI of *The Busi-*

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*ness of Trading in Stocks*, published by THE MAGAZINE OF WALL STREET. When applied to preferred stocks it yields, as will appear presently, rather surprising results.

### True Yield vs. Apparent Yield

The true investment yield of a security usually differs widely from its apparent yield. *True yield* takes both income and price appreciation into consideration, whereas *apparent yield* assumes that the entire income consists solely of dividend or interest receipts. In our short term note example, the true yield was 6%; but the apparent yield was the percentage ratio of \$50 to \$995.14, namely 5.03%. On bonds, the apparent yield is usually referred to as "Current yield"; but the rate known as "Yield to maturity" is synonymous with true yield only when the bond is held to maturity. True yield varies with current money rates, whereas yield to maturity presupposes a uniform rate of return on the investment. In the case of long term bonds, there is little difference between current yield and yield to maturity; but in other instances the current (apparent) yield on stocks and bonds is frequently a highly misleading guide to values, as was shown in Chapter III.

### Influence of Money Rates

It may be regarded as a fairly reasonable assumption that *the intrinsic value of good common stocks is at all times such that their true yield will be 2% above the prevailing rate for time money*. As a matter of experience it has been observed that market prices do tend to seek this level. It should be emphasized,

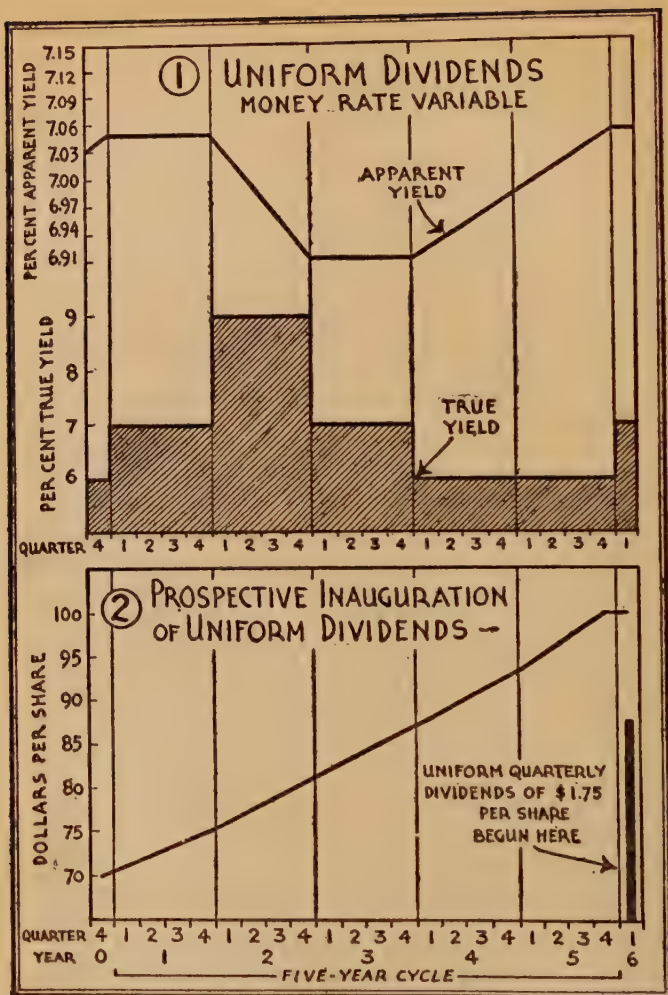
## Valuing the Common Stock on a New Basis

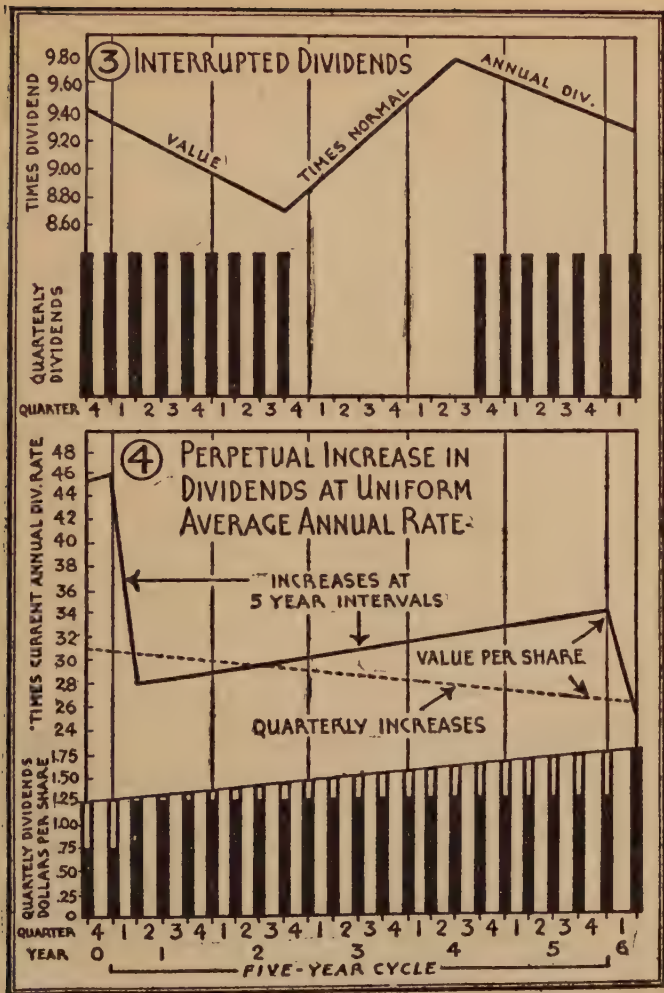
however, that we are now talking about investment worth—not market prices.

In order to determine the influence which fluctuations in the money market exert upon intrinsic values, let us assume the old fashioned economic cycle in which interest rates, profits, and security prices traveled a typical path of ups and downs about every five years. Suppose further that 5% is the prevailing rate for 90-day time money during the opening year of the cycle, 7% the second year, 5% the third year, and 4% during the fourth and fifth years. Common stocks should thus be worth a true yield of 7% during the first year, 9% the second year, 7% the third year, and 6% during the fourth and fifth years. This is indicated by the shaded area marked, "True yield," in number (1) of the accompanying graphs. Applying the present worth theory of intrinsic value, it is not difficult to compute that any stock which pays uniform quarterly dividends from now to the end of time, when valued according to the foregoing schedule of true yields, will follow a path indicated by the line marked, "Apparent yield."

Examination of Graph (1) yields several interesting conclusions, which apply not only to common stocks but also to non-callable preferred stocks:

1. If stocks always sold for true value, they would advance slightly during periods of tight money and decline a little while time money ruled below the five-year average rate. In other words, they would discount coming changes in interest rates. In practise they do the opposite. Even the highest grade bonds and preferred stocks decline with advancing interest rates, and hence fall below intrinsic values, under the influences of fear and forced liquidation. This leads to the practical rule that *Stocks whose dividends are uniform and unquestionably secure, become at-*





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*tractive as investments in proportion as their apparent yield rises above a five-year average. In applying this rule, however, it is important to recall that High current yields during a period of low interest rates frequently point to coming reduction in the dividend.*

2. Changes in intrinsic value during periods of abnormally high or low interest rates are just sufficient to compensate for differences between true yields and apparent yields. In order to bring out this point more clearly, let us assume that the line marked, "Apparent yield," in Graph (1), represents the price path of a 7% preferred stock which always sells at intrinsic value. Since the apparent yield is 7.05% at the beginning of the second year, and 6.91% at the end of that year; its price (value) must have been 99.3 (7 divided by 0.0705) at the beginning, and 101.3 (7 divided by 0.691) at the end of the second year. Within a year the market price thus advanced 2 points, or about 2%. Had we gone to the trouble of compounding the interest quarterly, as called for by theory, the enhancement in value would have been at the rate of 1.95% per annum which, added to the apparent yield of 7.05%, gives a true yield of 9%. During the fourth and fifth years, on the other hand, there would be a depreciation in values which, reduced to a percentage and subtracted from the apparent yield, would cause the true yield to drop to 6%.

3. At no time during the five-year cycle did the apparent yield, and hence the true value, of the stock swing as much as 1% away from the five-year average. This indicates that the *influence upon long range investment values exerted by changing conditions in the money market is so slight that, for most practical purposes, it may be neglected altogether.* This conclusion is so at variance with accepted beliefs, that we hasten to repeat that it applies to long term invest-

## Valuing the Common Stock on a New Basis

ment values; not to market prices. During the first five years (1914-1918) of banking experience under the Federal Reserve Act, 90-day time money averaged about 5%, which is the average rate used in computing the data for Graph (1). Granting, then, that it is reasonable for a long pull investor in common stocks to expect an average true yield of 2% above the rate for time money, in view of the risk involved, we shall simplify all further calculations by adopting the following restricted definition: *The intrinsic value of a common stock is the present worth of all future cash receipts from the investment, computed on a true yield basis of 7%.*

### Interrupted Dividends

Graph (3) shows the curve of intrinsic value, expressed as a multiple of the normal annual dividend rate, for a common stock that pays thirteen regular quarterly dividends during the five-year cycle, but omits dividends for seven consecutive quarters. It will be noted that:

1. The investment value here drops from a maximum of 9.84 times the normal annual dividend, just prior to resumption of dividends, to a low of 8.71 times the dividend, shortly before the dividend was omitted. The path of intrinsic value here resembles actual market performance insofar as it discounts coming changes in the dividend; but the maximum decline of 11.5% in intrinsic value is much less than the actual decline in market price which usually results from the omission of a dividend. Hence we find that: *Common stocks are frequently desirable purchases when the dividend is passed during times of depression in the industry.*

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2. In this example, the average value is about 9.28 times the normal annual dividend, and the average dividend during the five-year cycle is 0.65 times the normal annual dividend. Consequently the average intrinsic value, during the five-year cycle, is about 14.3 (9.28 divided by 0.65) times the average annual dividend. This is a special case of the following generalization: *If average dividends and earnings on a common stock remain stationery over any considerable period of time, its intrinsic value is 14.3 times the average annual dividend.* The rule applies regardless of whether dividends are regular or irregular as to amount and date of payment.

### Non-Dividend Payers

Graph (2) shows what a non-dividend paying stock is worth prior to inauguration of dividends at some time in the future. If the dividend, when inaugurated, is at the uniform rate of \$1.75 quarterly, for example, the stock will then be worth 100 (7 times 14.3). Five years earlier, according to the Graph, it is worth about \$71 a share. This explains why non-dividend paying stocks frequently sell at seemingly high prices. Table I gives the current investment values of a stock that will be worth 100 at various dates in the future:

It will be noted from Table I that *the income from*

TABLE I  
PRESENT WORTH OF \$100  
(True Yield 7%, Compounded Quarterly)

Years	Present Worth	Years	Present Worth	Years	Present Worth	Years	Present Worth	Years	Present Worth
0	100.0								
1	93.3	6	65.9	11	46.6	16	33.0	21	23.3
2	87.0	7	61.5	12	43.5	17	30.8	22	21.7
3	81.2	8	57.4	13	40.6	18	28.7	23	20.3
4	75.8	9	53.6	14	37.9	19	26.8	24	18.9
5	70.7	10	50.0	15	35.3	20	25.0	25	17.6

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*non-dividend paying stocks that "have a future," however remote, consists solely of appreciation in ones principal.* If such stocks always sold for true value, their market price would increase at the rate of about 7.2% annually in order to show a true yield of 7% compounded quarterly. For example: If a stock will be worth 100 ten years hence, it is worth 50 now. Next year it will be worth 53.6, which is an increase of 7.2%. This same rate of annual increase may be shown for any year in the table; so that the true yield always remains fixed at the rate of 7% per annum compounded quarterly.

### Growing Companies

The two curves in Graph (4) present typical paths of intrinsic value, expressed as multiples of the current annual dividend, for common stocks whose dividends are continually increasing at the average rate of a constant number of dollars per share per annum. The dotted line shows the course of values if dividends were increased quarterly: the zig-zag full line assumes the increases to take place at regular five-year intervals. In the example here selected, the average annual rate of increase is forty cents, and the five-year cycle opens with a quarterly dividend of \$1.25. Here investment values range from about 46 down to 24 times current dividends. Should 50% of earnings be paid out as dividends, the times-earnings ratio would be half the times-dividend ratio, and thus range from about 23 down to 12. A more rapid rate of increase in dividends, or earnings, would make a stock worth still higher ratios to dividends and earnings.

The sudden drop in the full line path at the beginning and end of the cycle is due to the abrupt increase in dividends, not to any fall in investment values. A

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stock which is worth 46.7 times a \$3.00 dividend, for example, will be worth only 28 times a dividend that has just been raised to \$5.00 per annum. Similarly, the value would drop from 33.6 to 24 times its annual dividend, when the latter is raised from \$5.00 to \$7.00. In each instance, the high ratio was merely anticipating an increase in dividend. The dotted line is free from conspicuous discontinuities, owing to frequent increases in the dividend.

### The Durand Formula

The dotted line in Graph (4) was computed by the "Durand Formula" for intrinsic values, originally presented as a footnote to Chapter XI of *The Business of Trading in Stocks*. Two years of experience with this method of appraising the investment values of industrial common stocks has confirmed its great practical utility, and so we reproduce the formula here for the convenience of present readers:

$$\begin{aligned} \text{If } y &= \text{True yield, expressed as a decimal,} \\ D &= \text{Annual dividend (\$ per share),} \\ d &= \text{Average annual increase in dividend (\$ per share),} \\ V &= \text{Intrinsic value (\$ per share),} \\ \text{Then } V &= \frac{D}{y} + \frac{d(4+y)}{4y^2} \end{aligned}$$

For any given current dividend and rate of increase in dividends, the formula enables one to compute the intrinsic value of any industrial stock to produce an assumed true yield on the investment, or to determine the true yield at any market price. It is not applicable to mining and oil stocks of limited life; nor to railroad stocks, so long as disputed questions of valuation and recapture remain to be adjudicated by the courts. The method of deriving this formula is rather too technical for presentation to the general reader; but

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those who are accustomed to algebraic processes employed in the summation of infinite series should encounter little difficulty in working out the problem for themselves.

### Special Cases

The Durand Formula may be reduced to simpler forms, which will be of greater practical service to the non-mathematically skilled reader, by making certain substitutions and transformations. For true yields of 7%, the general formula becomes (by substituting 0.07 for  $y$ ):

$$\text{Case I: } V = 14.3D + 208d.$$

Formula I is especially applicable where earnings have been irregular, though dividends have been increased persistently, over a considerable period of time. Translated into every day English, the rule would read: *The investment value of an industrial common stock with irregular earnings, but persistently growing dividends, is 208 times the average annual increase in dividend, plus 14.3 times the current annual dividend.* This is the rule that was used to compute the dotted line in Graph (4).

If per-share earnings and dividends have both been irregular, with no marked secular trend, over a considerable period of time, "d" would be zero in Formula I, which would then reduce to

$$\text{Case II: } V = 14.3D.$$

Expressed otherwise, the rule reads: *The investment value of an industrial common stock, whose earnings and dividends are both irregular and without secular trend, is 14.3 times the average annual dividend.* This is the rule that was mentioned in our discussion of Graph (3).

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The rule may be used to evaluate non-dividend payers by assuming that eventually a reasonable portion of average earnings will be disbursed as dividends. What proportion this will be can best be estimated by comparing the stock with others of similar character in the same industry. In the absence of any other guide, it may be considered reasonable to expect half of the average earnings to be paid out as dividends, and this leads to Rule III: *The investment value of a non-dividend paying industrial common stock, whose earnings are irregular and without secular trend, may be estimated at about seven times the average annual earnings per share.*

We come now to the class of stocks in which investors are most vitally interested, those which have demonstrated their ability to report ever increasing earnings over a considerable period of time. Here earnings are regarded as a more reliable guide to values than are dividends, because dividends must sooner or later fall into alignment with earnings. In practise, dividends do not follow earnings smoothly. This year only 40% of earnings may be disbursed as dividends. If earnings go on climbing for a few years, the dividend may be jumped suddenly to 60% of earnings, and remain steady at the higher level while earnings continue to climb until the ratio of dividends to earnings has again sunk to 40%. Now a stock which disburses 60% of its earnings as cash dividends is worth considerably more as an investment than one which pays out only 40%, as will be seen from Formula I. The modern stock market has thus come to look upon earnings as a more reliable guide to dividends and investment values than dividends currently paid. This conception calls for a change in Formula I, in order that values may be expressed in terms of earnings rather than dividends. Assuming

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that average dividends will, over a period of time, keep pace with the secular increase in earnings, the transformation is effected as follows:

$$\begin{aligned} \text{If } E &= \text{Current annual earnings (\$ per share),} \\ e &= \text{Average annual increase in earnings (\$ per share),} \\ r &= e/E \text{ (assumed to be also equal to } d/D), \\ \text{and } R &= D/E; \\ \text{then } D &= RE, \\ \text{and } d &= rD = rRE; \\ \text{Hence } V &= 14.3RE + 208rRE = ER(14.3 + 208r). \end{aligned}$$

Finally, if "r" be expressed as a percentage, instead of a decimal ratio, and the times-earnings ratio be denoted by "T," we have

$$\text{Case III: } V = ET, \text{ in which "T"} = R(14.3 + 2.08r).$$

Translated into terms which will be more comprehensible to readers without mathematical training, Rule III reads: *The investment value of a growing industrial common stock is computed by multiplying the times-earnings ratio by current annual earnings per share. To calculate the times-earnings ratio: first express the average annual increase in per-share earnings as a percentage of current annual earnings per share, multiply this percentage by 2.08 and add 14.3; then multiply this sum by the normal decimal ratio of dividends to earnings: the latter product is the times-earnings ratio.* For the benefit of readers who may not fancy the labor of applying either the Rule or Formula, we present in Table II an array of values for the times-earnings ratio, for various percentages of increase in earnings and a series of assumed ratios of dividends to earnings.

As an example of how the table is computed, take the case where earnings increase at the rate of 10% per annum, and half of the earnings are paid out as cash dividends: 10 times 2.08 is 20.8; adding 14.3, we have 35.1; and half (50%) of this is 17.55, which is slightly greater than the figure, 17.52, given

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TABLE II  
COMMON STOCK INVESTMENT VALUES  
Times-Earnings Ratios—For True Yield of 7%

COMMON STOCK INVESTMENT VALUES															
Times-Earnings Ratios—For True Yield of 7%															
Average Annual Rate of Increase in Earnings per Share (% of Current Earnings)	Normal Dividend (Average % of Current Earnings)														90
	25	30	35	40	45	50	55	60	65	70	75	80	85		
0.....	3.57	4.29	5.00	5.71	6.43	7.14	7.86	8.57	9.29	10.00	10.71	11.43	12.14	12.86	
1.....	4.08	4.90	5.71	6.54	7.35	8.17	9.00	9.82	10.64	11.45	12.27	13.09	13.91	14.73	
2.....	4.61	5.53	6.45	7.38	8.30	9.22	10.14	11.06	11.99	12.91	13.83	14.75	15.67	16.60	
3.....	5.13	6.16	7.18	8.21	9.23	10.26	11.29	12.31	13.34	14.36	15.38	16.41	17.44	18.47	
4.....	5.64	6.77	7.90	9.03	10.16	11.29	12.43	13.55	14.69	15.82	16.94	18.08	19.20	20.34	
5.....	6.16	7.40	8.63	9.86	11.10	12.33	13.57	14.80	16.04	17.27	18.50	19.74	20.97	22.21	
6.....	6.68	8.02	9.36	10.70	12.03	13.37	14.71	16.05	17.39	18.72	20.06	21.40	22.73	24.08	
7.....	7.20	8.64	10.08	11.52	12.96	14.40	15.85	17.29	18.74	20.18	21.62	23.06	24.50	25.94	
8.....	7.72	9.27	10.82	12.36	13.91	15.45	17.00	18.54	20.09	21.63	23.17	24.72	26.26	27.81	
9.....	8.24	9.89	11.54	13.19	14.84	16.49	18.14	19.78	21.44	23.09	24.73	26.38	28.03	29.68	
10.....	8.76	10.52	12.26	14.02	15.77	17.52	19.28	21.03	22.79	24.54	26.29	28.04	29.79	31.54	
11.....	9.28	11.14	12.99	14.85	16.70	18.56	20.43	22.28	24.14	25.99	27.84	29.71	31.57	33.43	
12.....	9.80	11.76	13.72	15.68	17.64	19.60	21.57	23.52	25.49	27.45	29.40	31.37	33.33	35.29	
13.....	10.32	12.38	14.44	16.50	18.56	20.63	22.71	24.77	26.84	28.90	30.96	33.02	35.08		
14.....	10.84	13.01	15.14	17.34	19.51	21.68	23.85	26.01	28.19	30.36	32.52	34.69			
15.....	11.36	13.63	15.90	18.18	20.45	22.72	25.00	27.26	29.54	31.81	34.07				
16.....	11.88	14.25	16.64	19.00	21.37	23.75	26.14	28.51	30.89	33.26					
17.....	12.40	14.87	17.35	19.83	22.31	24.79	27.28	29.75	32.24						
18.....	12.92	15.50	18.08	20.66	23.25	25.83	28.42	31.00							
19.....	13.43	16.12	18.80	21.49	24.17	26.86	29.57								
20.....	13.96	16.75	19.54	22.33	25.12	27.91									
21.....	14.48	17.37	20.27	23.16	26.05										
22.....	14.99	17.99	20.99	23.98											
23.....	15.51	18.61	21.71												
24.....	16.03	18.24													
25.....	16.54														

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in the Table, because the coefficients in Formula III are not carried out to so many decimal points as those employed in computing the Table.

Data in Table III, computed from the general "Durand Formula," enable one to determine the approximate true yield when dividends are, or may be expected to be, 50% of earnings, which is a common rate of disbursement among industrial common stocks. The wide range of times-earnings ratios displayed in Tables II and III brings out quite clearly the futility of expecting all common stocks, even within the same industry, to sell on the same times-earnings basis. This points to the greatest defect of the currently popular Out-of-line method of detecting investment bargains—its ambiguity. When stocks in one of these out-of-line arrays sell at comparatively low times-earnings ratios, one can never be certain whether they are actually underpriced, or merely worth less than the others. It is a common complaint of traders that stocks which already seem too high keep on rising, whereas issues which they consider to be cheap do nothing but decline after they buy them. Among a number of reasons for this distressing behavior there are two which may be appropriately explained here. The first is that market prices usually lag behind values that are changing rapidly in either direction, and seldom catch up until values cease to increase, or decrease, as the case may be. The second is that common stocks of growing companies always sell on a relatively high times-earnings basis, and naturally go on rising in market price, because their values are continually increasing.

In view of the well known stability of public utility earnings, one might expect that public utility common stocks would sell on a lower true yield basis than industrial common stocks. As a matter of experience,

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TABLE III  
COMMON STOCK INVESTMENT VALUES  
Time-Earnings Ratios—When Dividend is 50% of Earnings

Average Annual Rate of Increase in Earnings per Share (% of Current Earnings)	% True Yield									
	3 3/4	20	10	7	5	4	3 1/2	3	2 1/2	2
0.....	1.50	2.50	5.00	7.14	10.00	12.50	14.29	16.67	20.00	25.00
1.....	1.55	2.63	5.51	8.17	12.02	15.66	18.41	22.27	28.05	37.56
2.....	1.60	2.76	6.02	9.22	14.05	18.81	22.52	27.86	36.10	50.12
3.....	1.65	2.89	6.54	10.26	16.08	21.97	26.64	33.46	44.15	52.02
4.....	1.69	3.02	7.05	11.29	18.10	25.12	30.76	39.06	52.20	
5.....	1.74	3.16	7.56	12.33	20.12	28.28	34.88	44.65		
6.....	1.79	3.29	8.07	13.37	22.15	31.44	38.99	50.25		
7.....	1.84	3.42	8.59	14.40	24.18	34.59	43.11			
8.....	1.89	3.55	9.10	15.45	26.20	37.75	47.23			
9.....	1.94	3.68	9.61	16.49	28.22	40.91	51.35			
10.....	1.99	3.81	10.12	17.52	30.25	44.06				
12.....	2.08	4.08	11.15	19.60	34.30	50.38				
14.....	2.18	4.34	12.18	21.68	38.35					
16.....	2.28	4.60	13.20	23.75	42.40					
18.....	2.38	4.86	14.22	25.83	46.45					
20.....	2.48	5.12	15.25	27.91	50.50					
25.....	2.72	5.78	17.81	33.09						
30.....	2.96	6.44	20.38	38.29						
35.....	3.21	7.09	22.94	43.48						
40.....	3.45	7.75	25.50	48.68						
45.....	3.69	8.41	28.06	53.87						
50.....	3.94	9.06	30.62							
60.....	4.42	10.38	35.75							
70.....	4.91	11.69	40.88							
80.....	5.40	13.00	46.00							
90.....	5.89	14.31	51.12							
100.....	6.38	15.62								
150.....	8.81	22.19								
200.....	11.25	28.75								
250.....	13.69	35.31								
300.....	16.12	41.88								
350.....	18.56	48.44								
400.....	21.00	55.00								
500.....	25.88									
600.....	30.75									
700.....	35.62									
800.....	40.50									
900.....	45.38									
1000.....	50.25									

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however, we have found that Formulas I, II, and III, which are predicated upon a true yield of 7%, are equally useful in evaluating both industrial and public utility common stocks.

### Overdiscounting the Future

Values derived from Formulas I and III are what common stocks would be worth now if current dividend policies and rates of expansion in earnings were to go on forever. At first thought it would seem that stocks which sell at such values—and many do—must be dangerously inflated; for bear markets of the past have shattered many aircastles erected upon equally delusive foundations. It is characteristic of human nature to expect present conditions and tendencies to persist indefinitely. We can not seem to learn that change, not stagnation, is the universal law of Nature. There is a widely accepted belief, for example, that there can be no more major business depressions and bear markets under Federal Reserve regime, and this may partly account for the high levels at which many stocks are now selling. But however skeptical one may be of such assumptions the practical justification of the formulas is that, under conditions obtaining during the past few years, they have correctly forecasted the long range price movements of individual stocks. Viewed from another angle, however, values obtained from the Formulas do not discount the future so far ahead as the theoretical assumptions upon which they are founded would lead one to suppose. It can be shown by a mathematical transformation of Formula III, the details of which would be out of place here, that, if earnings continue to increase at the current rate for about  $14\frac{1}{2}$  years and then become stabilized at the new level, and the current ratio of

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dividends to earnings be maintained unchanged, a stock will then be worth its present value. In this sense, current values derived from Formula III, discount the future only 14.5 years ahead.

Any set of conditions selected at random, and illustrated by data taken from Table II, will make this thought clearer. Take the case of a stock whose earnings have been increasing at the rate of 10% per annum and upon which 50% of current earnings are disbursed as dividends. Should earnings continue to increase at the same rate forever, Table II, shows that the stock would now be worth 17.52 times current earnings; but if earnings suddenly cease to increase and become stabilized at the current rate, the stock is worth only 7.14 times current earnings. Here we have a precipitate drop of 59% in intrinsic value, which proves quite forcibly that earnings must keep on increasing to justify a high times-earnings valuation. To quote Alice in Wonderland (from memory): "Where I live, we have to keep on running and running to stay where we are." On the other hand, if earnings increase for only 14.5 years, at the rate of 10% of current earnings, they will then be 145% (14.5 times 10%) greater than current earnings; so that earnings 14.5 years from now will be 2.45 times current earnings. If earnings then stop growing, and become stabilized at the higher level, the stock will be worth 17.52 (which is 2.45 times 7.14) times current earnings, which is the same as its current value. The proof of this is that dividend payments after 14.5 years, if still at the rate of 50% of earnings, would be 1.225 (50% of 2.45) times current earnings, which is 7% of the stock's current value (17.52 times current earnings). Thenceforth the entire income on the investment would come from dividends, and none from price appreciation. At the beginning, the current

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yield from dividends was only 2.85% ( $\frac{1}{2}$  of current earnings divided by 17.52 times current earnings). Stated otherwise: if a person buys a stock of these characteristics at a time when it shows a current yield of only 2.85%; within 14.5 years the dividend will have been increased to a point where cash income yields him 7% on the original investment. Had earnings gone on increasing forever at the rate of 10% per annum, as anticipated at the time of purchase, what was sacrificed in cash income during these 14.5 years would have been offset by a corresponding increase in principal; but, as earnings stopped growing after 14.5 years, the stock was then worth exactly what it originally cost him, and thus failed to compensate for the many years of subnormal income. It sometimes happens that a high times-earnings ratio also discounts an increase in the proportion ("R") of earnings that are to be disbursed as cash dividends. Formula III shows that intrinsic value is directly proportional to "R." When, for example, a company which has been paying out 50% of its earnings as dividends suddenly alters this policy and begins to disburse 75% of earnings, the common stock is thereby enhanced 50% in value. It is customary to devote part of the profits, which are withheld from stockholders, to expansion and part toward modernizing the plant. Should the company cease growing, and earnings become stabilized, it is sometimes customary to disburse in dividends the part of earnings which had formerly been used for expansion; and an increase in dividends at this juncture may serve to avert the shrinkage in intrinsic value which would otherwise result from cessation of the growth in earnings. In instances where "R" is increased when earnings cease to expand, Formula III may actually discount the advent of a normal cash yield (7%) only a few years

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in advance, as the following example taken from data in Table II will show: If "R" is 50%, and "r" 5%, intrinsic value is 12.33 times current earnings. In three years, earnings will grow to 1.15 (1, plus 3 times 0.05) times current earnings. If earnings then stop growing, and become stabilized at the higher level; and if dividends be raised to 75% of earnings; intrinsic value will be 12.33 (1.15 times 10.71) times current earnings, which is equal to the stock's initial value; and the cash dividend yield will be 7%. Here the increase in dividend was discounted only three years in advance, despite the fact that the stock's initial value was derived from a formula based upon a continuation of past tendencies to the end of time. In this example, as in that of the foregoing paragraph, the initial value was overoptimistic, however, in forecasting an appreciation in principal which failed to materialize. The investor was merely fortunate, in both instances, that there was no shrinkage in his principal, when the future grew weary of perpetuating the past.

The hazards attendant upon valuing stocks according to the foregoing formulas rest chiefly upon the possibility that earnings at some time in the future may not continue to increase so rapidly as in the past. In instances where earnings do slow down, however, the consequent decline in market price—especially in a bull market—is not so rapid nor severe as one might imagine. Investors generally refuse, and rightly, to construe a single year's decrease in earnings as convincing proof of a permanent reversal in trend; for sporadic irregularities are frequently caused by non-recurrent expenses, bookkeeping conventionalities, or mere accident. But the Out-of-line method will some day be called to account for the severe deflation which is bound to occur sooner or later in the currently over-

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priced issues of a number of stagnant companies. Among these are certain gas stocks whose earnings have remained practically stationary for several years, and upon which dividends are being paid at the rate of about 80% of average earnings. According to Table II, these are worth about 11.43 times earnings; but are currently selling at 20, and even 30, times average earnings, in emulation of healthily growing electric power and light stocks with which they have been illogically compared in popular out-of-line analyses of "The Public Utilities."

### Compensating for Changes in Capitalization

The real trend of per-share earnings is frequently covered up by readjustments in a company's capital structure. Secular comparisons of changes in market prices, cash dividends, and per-share earnings should therefore be compensated for stock dividends, rights and exchanges before estimating values by our tables and formulas. When allowing for increases in the amount of stock outstanding, however, consideration should be given only to securities donated to common stockholders. No readjustments should be made for securities issued for cash; because funds thus procured are supposedly used to expand income or reduce costs. For example: last year, a certain company reported net earnings of \$10.00 a share; this year it pays a 100% stock dividend, or else splits its common stock 2:1; for the current year, earnings amount to \$6.00 a share on the new capitalization. Earnings last year were thus equivalent to \$5.00 a share in terms of the new stock; for the holder of one new share then owned only half a share of the old stock and thus had the benefit of only half of the ten-dollar earnings. The apparent decrease of 40% in per-share earnings

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is thus shown to be really an increase of 20%. On the other hand, if one new share had been issued for cash, and earnings of \$11.00 were then reported the second year; there should be no adjustment of earnings for the increased amount of common outstanding, and the true increase in per-share earnings would have been 10%, as reported.

The distribution by Coca-Cola to Common stockholders, early this year (1929), of one share of \$3 Preferred "A" for each share of Common held, calls for a somewhat different compensation. Since payment of \$3 on the new Preferred takes \$3 from earnings formerly applicable to the Common stock, this amount must be subtracted from per-share earnings as reported in former years before comparing those earnings with per-share earnings for 1929 and subsequent years.

U. S. Steel may be used to illustrate the method of compensating for rights. In the early Spring of 1929, this corporation offered to Common stockholders the right to subscribe, at \$140, to one share of new Common for each seven shares of old Common held. In other words, each holder of 1 old share could subscribe, at \$140, for  $1/7$ th share of the new. The cost of  $1/7$ th share would thus be \$20. Steel opened, ex-rights, at about 184: hence \$20 would have bought  $20/184$ th of a share, namely about  $1/9$ th of a share, in the open market. The difference between  $1/7$ th and  $1/9$ th of a share was thus equivalent to a stock dividend. Using exact figures, in place of the approximation, we discover that the rights concealed a stock dividend of 3.43%. Per-share earnings prior to 1929 should thus be divided by 1.0343, for purposes of secular comparisons. In addition, earnings prior to 1927 should be divided by 1.4 to compensate for the 40% stock dividend declared in

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that year. Another interesting case in point is American Telephone and Telegraph. In view of the seemingly stationary character of per-share earnings, as officially reported; current market prices for the stock seem unwarrantedly high, until one takes account of the long series of stock dividends that lie hidden in the intermittent offerings of rights.

Market prices and cash dividends of former years should be reduced to compensate for stock dividends, in the same manner as per-share earnings.

Savings in prior charges effected by retirement of bonds and preferred stock out of working capital, should be added to common stock earnings of former years; thereby correcting a spurious rate of increase in earnings which can not be maintained. Increases in corporation income taxes, resulting from bond retirements, should be deducted from common stock earnings of former years. Common stock earnings of former years should also be compensated for changes in prior charges that result from refunding operations; but should not be compensated for increases in prior charges arising from the sale of bonds and preferred stock for other than refunding purposes.

### Estimating the Rate of Growth

It will be noted, perhaps, with surprise, that our formulas for intrinsic value attach no significance to such often emphasized items as working capital, current assets, surplus, book values, and other indexes of financial strength. This is because the assets of a going concern are of no direct value to a stockholder until they reach him in the form of cash dividends. If there are prospects that a company may soon go into liquidation, the value of its common stock would become equal to the present worth of net tangible

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assets: otherwise, an analysis of assets and liabilities is only of indirect value as an aid to estimating the future trend of dividends.

Since investment values are wholly dependent upon current earnings and dividends, and their future rate of increase, great care must be exercised in estimating the probable trend. Besides compensating for changes in capitalization, the investor must give consideration to a number of other circumstances—such as, trend of gross income, peculiarities in accounting practice, non-recurrent income and expenses, changes in management and banking connections, future competition, and industrial outlook.

In the long run, profits cannot increase more rapidly than gross income; for there is always a limit to cost reductions. This is one reason why the railroad stocks, as a group, have not responded to recently reported gains in net income. Investors realize that gross income remains practically stationary, and that the gratifying showing made by earnings is due to economies in operation which can not be continued indefinitely.

For purposes of observing the current trend of earnings and dividends, it is especially important to use good judgment in selecting the years between which comparisons are made. Few companies are able to report an unbroken succession of yearly increases in earnings. Earnings, like market prices, tend to move in cycles. To compare the peak year of one cycle with the poorest year in some earlier cycle, would obviously lead to an exaggerated conception of the trend. It is usually best to compare the most recent peak with that of the immediately preceding cycle; but the choice of years will depend somewhat upon the prevalent attitude of investors. After several years of advancing market prices, investors are

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prone to predicate values upon only two years of rising trend.

Two years is the shortest interval that should ever be used for estimating the trend of earnings; for profits of a single year are frequently thrown out of line by inventory and other adjustments which may be reversed the next year. More conservative estimates of secular growth usually result from comparisons with like situated years prior to the latest business depression. After comparing the earnings of 1928 with those of 1926, for example, it is safest to see how this trend checks up with that observed between 1923 and 1928, before concluding definitely that a stock is greatly undervalued; and, if one chooses to be ultra conservative, 1928 may be compared also with 1918. There is something to be said, however, in behalf of the two-year comparison. We are in an era of rapid changes, and current trends may not equal those of five years ago; and probably are not comparable with those of a past decade. The investor should bear in mind that our formulas merely show the intrinsic value which would logically result from persistence of an assumed trend, and so are no more accurate than the assumption. After all, what we want to compute is the value toward which market prices tend to gravitate in the long run, and this depends upon what people believe the trend to be: not upon what it actually is.

Market prices may never reach values based upon abnormal current trends; because the trend is likely to change too soon. This is why it is so important for the investor to forecast the trend correctly for as many years in advance as possible. Only an experienced analyst, in constant touch with the market pulse, can do this successfully; and it is greatly to the credit of American investors that those who lack

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time to study the subject exhaustively are tending more and more to seek the advice of disinterested and properly equipped experts.

### Practical Applications

The following examples will help to clear up some of the questions that commonly arise in applying the foregoing tables and formulas to everyday investment situations: All earnings and dividends are compensated for changes in capitalization.

*National Biscuit.* Earned \$1.66 in 1918, \$5.06 in 1923, \$6.32 in 1926, and \$7.31 in 1928. The average annual increase in earnings, in this instance, has been remarkably uniform. During the ten-year period, from 1918 to 1928, it averaged \$0.56 per share; during the five-year period, between 1923 and 1928, the average was \$0.45; and during the most recent two-year interval, 1926-1928, the average increase was \$0.50. We shall therefore be reasonably safe in assuming that an average yearly increase of \$0.50 is well established. This is 6.83% of the 1928 earnings. During the past few years, dividends have averaged about 82.5% of earnings. Substituting  $r=6.83$ , and  $R=0.825$ , in Formula III; we find that the stock should be worth 23.5 times the 1928 earnings of \$7.31, namely about \$172 a share. The high this year to date (May 11, 1929) was 205; the low, 168; and the most recent price (on May 11), 180. During the two-year interval, between 1925 and 1927, the average annual increase in per-share earnings was \$0.67, and 85.4% of the 1927 earnings were paid out as dividends during 1928. This would make the stock worth 205, and explain the 1929 high. The subsequent drop to 168 followed publication of the 1928 earnings.

National Biscuit is one of many stocks whose mar-

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ket prices tend to follow values based upon current dividends and the latest two-year earnings record, as will be seen from the following table:

Year	Value	Next Year's	
		High	Low
1926.....	144	187	95
1927.....	205	195	160
1928.....	170	205	168

In other words, the two-year trend furnishes the best guide for speculators; but investors will find it safer to base the earnings trend upon an interval which includes the last industrial depression.

*Coca-Cola.* Average dividend is about 60% of earnings. Earned \$1.53 in 1923, \$5.25 in 1926, and \$7.19 in 1928. Average annual increase during past five years was \$1.13, or 15.7%; but only \$0.97, or 13.5%, during the past two years. With trend predicated upon a five-year comparison of earnings, intrinsic value (by Formula III) figures out to be 198; whereas, on the two-year basis, it is worth 178. At current market price of 130, the stock seems to be a good long-pull investment opportunity; but it may be that investors fear the possibility of future competition with other soft drinks of growing popularity.

*Canada Dry Ginger Ale* also appears to be even cheaper, perhaps for similar reasons. Earnings were \$3.85 in 1926, and \$6.10 in 1928. Dividends run about 55% of earnings; so that intrinsic value, computed from the two-year trend, is about 174. Current market price is around 86.

*Allied Chemical*, on the other hand, looks too high. Earned \$7.65 in 1923; \$9.78 in 1926, and \$11.12 in 1928. Dividends average 60% of earnings. On five-year trend, is worth \$182. Two-year trend gives a value of \$179. Current market price is \$286. Stock is discounting, perhaps too optimistically, additional

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profits from the new nitrate plant which is being financed out of working capital.

*Coty* is a beautiful example of a stock whose market price swiftly caught up with value. Publication of the annual report for 1926 showed the old stock to be worth 230. Shortly before the report came out, early in 1927, the stock sold as low as 56. The high that year was 123. Next year the new stock, after the 4:1 split-up, reached 90; which was equivalent to 360 for the old stock, and overpriced. The 1928 report showed the new stock to be worth 77, on a two-year trend basis. Its recent price (May 11, 1929) was 67, with a 1929 high to date of 82.

*Fleischmann* is an interesting example of a stock whose market price refused to meet computed values, because investors doubted that earlier rates of increase in earnings could be maintained. Their skepticism was justified by subsequent reports of earnings. On a two-year trend basis, the stock was worth 188, in 1927, but sold no higher than 71; in 1928, the price reached 89, and computed value dropped to 131; this year the stock is worth only 65, and now sells for 70. Here we find that intrinsic value came down to meet the market price. Both are sure to meet eventually.

*Shattuck* illustrates the case of a stock which is discounting an early increase in dividend. The stock earned \$6.26 in 1928, but now pays only \$2.00. In former years, 50% of earnings has been disbursed to stockholders. With a \$2.00 dividend, the stock is worth only 91; but would be worth 142, if dividends were 50% of earnings. The stock now sells for 146.

*U. S. Steel*. Irregular earnings, but steadily increasing dividends. Hence value should be computed by Formula I. Compensating for rights and stock dividends, we find that the cash dividend was raised to \$3.45 in 1922, and finally to \$7.00 in 1929. The

## Valuing the Common Stock on a New Basis

average annual increase, "d", during the seven-year period, was therefore \$0.507. Substituting in Formula I, we find the stock to be worth 205. It now sells for 180, ex-rights.

*New York Air Brake.* Irregular earnings: steady dividends of \$3.00 for past five years. Hence, by Formula II, stock is worth 43. Current market price is 44.

*U. S. Cast Iron Pipe.* Earnings decreased each year since 1924. Has paid \$2.00 for past three years. Earned \$1.62 in 1928. If steady dividend of \$2.00 can be maintained, stock is worth 29 (by Formula II). In view of coming competition with new wrought iron pipe process, current price of 42 seems too high.

*National Enameling.* No dividends since 1923, until this year. Deficit in 1926 and in 1927. During 1918 to 1921, inclusive, paid \$6.00. New management recently inaugurated. Initial dividend of \$1.00 just declared. If stock were to pay steady dividend of \$4.00, it would be worth 57 (Formula II). Currently sells for 50.

*North American.* Steadily increasing earnings. Has paid 10% stock dividends each year since 1923; but no cash dividends. Earned 3.85 in 1926, and 4.51 in 1928, on actual number of shares outstanding. Compensated for stock dividends, 1926 earnings were thus equivalent to 3.18. Two-year increase in earnings was therefore 29.5% of 1926 earnings. The Company could discontinue stock dividends, and pay out 60% of earnings as cash dividends. If this were done immediately, the stock would be worth 119. Current market price is 113. This is almost a perfect illustration of the general principle that: *Stocks listed on the New York Stock Exchange tend to discount cash dividends that could be paid, regardless of dividends actually paid.* We have not tested the "Durand

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Formula" on Over-the-counter stocks, or issues listed on other exchanges.

### A New Out-of-Line Method

In Table IV, the intrinsic values of a number of miscellaneous common stocks are calculated on the basis of *normal* (not current) dividends, and the five-year trend of earnings between 1923 and 1928. Unless otherwise stated, all data are expressed in dollars per share.

TABLE IV  
NEW OUT-OF-LINE DATA

Stock	Compensated Earnings		Normal Dividend	Ave. Increase in Earnings		Computed Times Earnings Ratio	Market Price (5-11-29)	
	1923	1928	% of 1928 Earnings	\$	% of 1928 Earnings		Intrinsic Value	
				per Share				
Allied Chemical.....	7.65	11.12	60.0	0.69	6.24	16.4	182	286
Allis Chalmers .....	7.55	11.28	65.0	0.75	6.64	18.3	206	200
American Smelting...	3.31	8.24	40.0	0.99	12.02	15.7	129	105
Amer. Tel. & Tel.....	9.58	12.11	80.0	0.51	4.21	18.5	223	220
Amer. W. W. & Elec.	1.78	3.50	60.0	0.34	9.84	21.0	73	89
Beechnut Packing....	5.37	6.51	55.0	0.23	3.54	11.9	78	83
Coca-Cola .....	1.53	7.19	70.0	1.13	15.70	32.9	231	130
General Motors .....	1.42	6.14	60.0	0.94	15.30	27.7	170	83
Intntl. Tel. & Tel.....	6.08	9.68	60.0	0.72	7.44	17.9	173	270
Kresge (S. S.).....	1.70	2.81	50.0	0.22	7.83	15.3	43	49
Liggett & Myers.....	3.81	6.82	70.0	0.60	8.80	22.8	156	91
National Biscuit.....	5.06	7.31	75.0	0.45	6.16	20.3	148	180
Western Union.....	13.64	15.41	55.0	0.35	2.29	10.5	162	197
Westinghouse Mfg....	7.96	8.78	50.0	0.16	1.87	9.1	80	164
Woolworth (F. W.)	5.31	9.07	50.0	0.75	8.27	15.8	141	232

When market prices differ greatly from computed values, it is well not to jump immediately to the conclusion that the former are out of line. It may be that the rate of growth, upon which these values are founded, is out of line with future probabilities. American Smelting, Coca-Cola, and General Motors are perhaps selling below intrinsic values based upon past rates of growth because investors doubt if such

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rapid increases in earnings can be maintained indefinitely. Western Union and Westinghouse, on the other hand, are undoubtedly selling above computed values because it is believed that the future holds brighter prospects in store for both companies. The 2% rate of increase in earnings does indeed seem subnormal.

In view of the rapid growth in wealth of the United States, it is quite reasonable to expect the earnings of well managed corporations to maintain an average rate of increase in earnings ranging from 6 to 10%. If earnings grow persistently at an average annual rate of 8%, and 60% of earnings are disbursed as cash dividends, the common stocks of such companies are worth logically about 18.5 times earnings. For a stock to be worth 30-times earnings, however, calls for a persistent annual increase of over 17% in earnings, and this does seem a little unreasonable. *The outstanding advantage of the "Durand Method" of valuing stocks is that it enables the investor to analyze the character and magnitude of future possibilities which current market prices are undertaking to discount.*



## CHAPTER V

### Many Money Market Theories Now Obsolete— New Monetary Influences and the Stock Market

#### A New Era?

WE are greatly indebted for the introductory data in the present chapter to a scholarly address delivered before the Connecticut State Bankers Association, in February of 1929, by Dr. Benjamin M. Anderson, economist of the Chase National Bank of the City of New York.

"That we live in a 'new era,'" says Dr. Anderson, "in which the laws of economics are suspended, in which all financial records are broken, and in which an indefinite continuance of the breaking of financial records may be confidently looked forward to, is believed by a good many people. Many men whose financial education began in the quiet period that ran from 1908 to 1914, are a good deal puzzled by the developments of the past seven years. But veterans whose memories go back to the middle 'Nineties, remember another 'new era,' not less remarkable in its financial demonstrations, and a good deal more impressive on the side of the production, transportation, and exchange of goods, running from 1896 to 1903 . . . Few American bankers remember the still earlier 'new era,' running from 1877 to 1881, during which the average price of sixty

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active railway stocks advanced from a low of 20.58 to a high of 101.54—a high level, which, incidentally, was not reached again until 1901.”

“Even before 1877, there was more than one ‘new era’ in American finance, but the records are scant and the lessons to be drawn from their study are, perhaps, of uncertain application to the present day. In the case of the ‘new era’ of 1896-1903, however, the records are full enough, and the analogies are close enough, to make it distinctly profitable to compare it with our own ‘new era.’ There are highly important resemblances and some significant differences. If the study does nothing else, it will at least convince us that economic laws are not suspended, and that like causes generate like results.”

“Both ‘new eras’ were inaugurated and accompanied by a rapid growth in the monetary gold stock of the country, and by a resultant rapid expansion of bank credit. . . . Both periods exhibited an immense increase in bank loans against stock and bond collateral . . . but the second ‘new era’ has exhibited an absolute decline in commercial loans. . . . The earlier ‘new era’ on the other hand, as the consequence of rising commodity prices and great business expansion, showed a growth of 68% in the ‘all other loans and discounts.’ . . . It is clear that the second ‘new era’ is much more a matter of expanding finance than of expanding commerce. . . . This is emphasized by the behavior of figures for money in circulation, which are in many ways an index of commerce and industry, and which are especially affected by rising or falling commodity prices. . . . Both periods are characterized by rapidly rising prices in the stock market, the railroad stocks, however, monopolizing interest in the first ‘new era,’ whereas the industrial common stocks had the center of the stage in the second ‘new era.’

## New Monetary Influences and the Stock Market

... The earlier period was characterized likewise by a great increase in new security issues, and by numerous consolidations in which new securities replaced old ones."

"It is interesting to observe that both periods have been characterized by a growing interest in stocks as compared with bonds on the part of the public, though this interest manifested itself much later in the present 'new era' than it did in the earlier 'new era.' It is also interesting to observe that following the break in stock prices in 1903, the preference shifted, so that the listing of stocks declined sharply, and the listing of bonds became much the preponderant thing."

"The first 'new era' began *at the end* of a period during which the world had been moving to the gold standard, and during which there had been intense competition among the different nations of the world for their share of an inadequate gold supply. It was ushered in and accompanied by growing world gold production and by a cessation in the international scramble for gold. The present 'new era' has already witnessed *the beginning* of a new international competition for gold, and it sees a world gold production, large to be sure, but still well below the figures from 1907 to 1915."

"The earlier 'new era' witnessed a prosperity which was shared by all the major elements of American economic life, including very especially agriculture. The present 'new era' has seen a great deal of agricultural distress."

"It would be a mistake to try to draw any conclusions whatever from this parallel between the events of twenty-five or thirty years ago and those of today, with respect to the timing of future events, or the probable length of life of the present 'new era.' His-

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TABLE I  
TWO ERAS OF CREDIT EXPANSION

	Early Era			Recent Era		
	1896	1903	% Increase	1921	1928	% Increase
Exports (millions) .....	1006	1485	48	4485	5129	17
Imports (millions) .....	682	995	46	2509	4090	63
World gold production (millions)..	202	328	62	319	401	26
U. S. Monetary gold stock (millions) .....	503	1121	123	2942	4379	49
Individual deposits in commercial banks (millions) .....	3010	6738	124	29831	43233	45
Common Stk. listings N. Y. S. E. (% of total).....	22.2	66.8	201	.....	.....	.....
New capital issues (Stocks, % of total) .....	.....	.....	.....	7.5	37.4	399
Transactions N. Y. S. E. (million shares) .....	53	266	397	172	920	436
Price N. Y. S. E. seats (thousands) ..	14	82	486	78	595	668
Common stock price index.....	100	474	374	100	553	453
Loans on stocks and bonds (millions) .....	627	1373	119	2699	5114	89
Physical volume of production (index) .....	100	143	43	100	135	35
Volume of R. R. transportation (index) .....	100	177	77	100	135	35
Dollar value of production (index) ..	100	184	84	100	135	35
Wholesale price index.....	100	128	28	100	100	0
Money in circulation (millions)....	858	1362	59	4911	4797	2-d
Commercial loans (millions).....	1250	2109	69	9025	8745	3-d

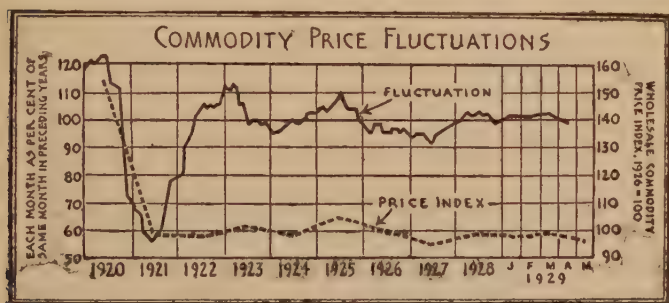
d-Decrease.

tory repeats itself after a fashion, but with many differences, and, above all, with great variations in the amount of time required for particular phases to recur. It is sufficient for the present to conclude that our own 'new era' is not, after all, so very new in principle, that like causes produce like results, that excessive gold and excessive bank reserves generate bank expansion, that bank expansion running in excess of commercial needs will overflow into capital uses and speculative employments, and that low interest rates and abundant credit will ordinarily reflect themselves in rapidly rising capital values."

## New Monetary Influences and the Stock Market

### Commodity Prices

The greatest contrast between the two periods lies in the conspicuous stability of commodity prices during the recent era compared with rapidly rising prices of the earlier seven-year interval. This is sometimes ascribed to the higher degree of control exercised over production and prices of recent years through the agency of export and trade associations, and to the hand-to-mouth buying habits which our merchants and producers have acquired since the War. But



there is always a tendency to attribute world wide economic developments to local causes and human effort—like Chanticleer, who believed the sun could not rise without his crowing. In this instance, it seems more likely that our stationary commodity price index (see accompanying chart) reflects a stalemate between domestic inflationary forces and the deflationary influences of world wide overproduction of raw material and plant capacity. Hand-to-mouth buying is probably a result, not the cause, of steady to soft commodity prices. It is perhaps fortunate for our new trade associations that the present era

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has not developed the conspicuous rise in commodity prices of 1896-1903, which moved Congress to pass the Sherman anti-trust law. The trusts were probably no more responsible then, for the inflation in commodities than speculators are now for the expansion in brokers' loans; but politicians are again eager to try their hands at stemming the tide. People speculate because prices are rising; but no amount of manipulation can long check a wave of receding prices that comes from world wide economic causes. Speculation is a result, not the cause, of inflationary movements.

## How We Became a Creditor Nation

Returning to Dr. Anderson's illuminating parallel: "It is to be observed that the lower percentage of increase in gold in the later 'new era' is partly offset by the fact that the war years preceding had brought in a great deal of gold, the monetary gold stock having risen from \$1,905,000,000 at the beginning of 1914 to \$2,942,000,000 at the beginning of 1921. Much of the influence of this had been spent, however, by the immense expansion of bank credit between 1914 and 1921, and an increase of 16.2 billion dollars in deposits, or of 118.6%. The great break in commodity prices in 1920-1921 released a large volume of bank credit that had been employed in commercial loans, and bank credit in the United States would have declined, instead of expanding, after 1921, had the outside world been in a position to draw away our excess of gold. But the world outside had been driven off the gold standard, and, through the workings of Gresham's law, continued to send us gold instead of taking gold from us. We have thus had available for uses other than commercial loans not only the whole

## New Monetary Influences and the Stock Market

of our increase in bank credit since 1921, but also a substantial part of the bank credit outstanding at the beginning of that year. Chief among these other uses have been real estate mortgage loans, instalment finance paper, bank investments in securities, and collateral loans against securities."

It will help to understand this account of our change from a debtor to a creditor nation if we observe that the history of our foreign trade may be divided conveniently into the five periods shown in Table II.

TABLE II  
U. S. BALANCE OF TRADE  
(Millions)

Period	Average Annual Excess Exports
1776-1875.....	30-d
1876-1897.....	117
1898-1914.....	500
1915-1920.....	3163
1921-1928.....	854

---

d-Excess imports.

"One big factor in the amount of the export figures in the first 'new era' was the rising value of our export crops, notably wheat and cotton, a phenomenon which has not appeared in the later period. Partly the export balance grew out of our imports of gold. We did pay off debts, however, in the earlier period, and even made some subscriptions to European loans in 1900, which helped get our exports out. Further, as our securities rose to very high levels, Europeans sold back to us at high prices a good many of our securities which they had previously bought from us at low prices, which again helped to get our exports out. With rapidly expanding credit facilities in the United States, moreover, we needed to borrow very much less from Europe. We were definitely in the second phase of the debtor country's history, the paying phase as opposed to the borrowing phase. In the borrowing

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period, the debtor country has an import surplus—that is the way in which it receives the proceeds of foreign credits. In the second, or paying period, the debtor country has an export surplus—that is the way in which it repays.”

“The creditor country, like the debtor country, has also two periods in its history. The first is the lending period during which it sends out the proceeds of loans it makes in the form of goods. We entered this period during the War and post-War boom on such a colossal scale that it seemed inevitable that the repayment of interest alone would speedily eliminate our export surplus. But, by virtue of our immense expansion of bank credit, we were able to prolong it, though down to the middle of 1928 it required an ever increasing volume of foreign loans to accomplish this.”

The Department of Commerce is authority for the summary, presented in Table III, of total foreign securities, government and corporation, publicly offered in the United States between 1914 and 1928. The fig-

TABLE III  
NET FLOTATIONS OF FOREIGN SECURITIES IN THE UNITED STATES  
(Millions)

1914.....	38
1915.....	814
1916.....	1,123
1917.....	686
1918.....	28
1919.....	562
1920.....	485
1921.....	631
1922.....	682
1923.....	414
1924.....	928
1925.....	1,085
1926.....	1,135
1927.....	1,376
1928.....	1,251
Total .....	11,238
Government .....	6,681
Corporation .....	4,557

## New Monetary Influences and the Stock Market

ures are for new capital, exclusive of refunding, and do not include any of the war loans made to the allied nations or capital privately invested abroad:

"In the second half of 1928, in view of our tight money, it became difficult to place foreign securities here. Nevertheless, we are today (Feb., 1929) a heavy debtor, on current account, to the outside world, our takings of foreign loans having exceeded our commodity export balance to such an extent as to leave the outside world with a temporary surplus of current dollar assets over current dollar obligations. The outside world holds today the major part of the acceptance liabilities of American banks, and has a large volume of funds loaned on call to our stock market. . . . So long as borrowed dollars are available in adequate volume, our export trade can be maintained, and can even grow, and an export balance could be preserved. But, when the borrowed dollars are used up, the second phase of the creditor country's position will present itself, the phase in which it receives an import surplus of goods. This import surplus may arise either from an increase in imports or from a falling off in exports, depending upon the foreign trade policy of the United States."

### Internationalism

Such is the classic economic view of the relation between commodity and capital exports. In practice, it is extremely difficult to forecast the trend of international gold movements very far ahead. There are many so-called "invisible items" on the international balance sheet which offset the large and obvious items. The following adaptation of estimates just published by the Department of Commerce shows how complicated the subject really is:

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TABLE IV

ESTIMATED BALANCE OF INTERNATIONAL PAYMENTS TO AND BY  
THE UNITED STATES, 1928

(Millions)

	Credits	Debits	Balance Plus Minus	
FOREIGN TRADE				
Merchandise exports and imports.....	5,129	4,091	1,038	.....
Unrecorded parcel post shipments.....	20	20	.....	.....
Sales of vessels.....	3	3	.....	.....
Silver .....	87	68	19	.....
Subscriptions to periodicals.....	5	3	2	.....
Imports of Canadian electric power.....	.....	3	.....	.....
Sundry adjustments .....	.....	256	.....	256
Totals .....	5,244	4,444	800	.....
TRANSPORTATION AND COMMUNICATION				
Bunker coal and oil.....	50	25	25	.....
Ship chandling, ship repairs, and tonnage dues	45	34	11	.....
Freight charges .....	143	227	.....	84
Ocean-borne passenger traffic .....	89	.....	89	.....
Cablegrams, radiograms, and telephone service .....	23	19	4	.....
Totals .....	350	305	45	.....
SERVICE				
Consular services, and other Government payments .....	53	110	.....	57
Missionary and charitable contributions.....	.....	52	.....	52
Underwriters' commissions on foreign securi- ties offered in U. S.....	59	.....	59	.....
Advertising .....	3	13	.....	10
Totals .....	115	175	.....	60
ROYALTIES, PATENTS, INSURANCE				
Motion picture royalties.....	70	6	64	.....
Patents and copyright sales and royalties.....	15	15	.....	.....
Insurance transactions .....	80	70	10	.....
Totals .....	165	91	74	.....
LONG TERM INVESTMENTS				
Direct investments .....	70	378	.....	308
Resale of direct investments.....	50	.....	50	.....
Net value of new securities, publicly offered..	.....	1,420	.....	1,420
War debt principal.....	50	.....	50	.....
Other refunding, redemptions, and sinking fund payments .....	598	70	528	.....
Open market purchases of stocks and bonds....	1,445	500	945	.....
Open market resales of stocks and bonds.....	400	1,030	.....	630
Totals .....	2,613	3,398	.....	785
NET CHANGE IN CURRENT INDEBTEDNESS				
Totals .....	.....	226	.....	226

# New Monetary Influences and the Stock Market

TABLE IV—*Continued*

ESTIMATED BALANCE OF INTERNATIONAL PAYMENTS TO AND BY  
THE UNITED STATES, 1928

(Millions)

	Credits	Debits	Balance	
			Plus	Minus
LONG TERM INVESTMENTS				
INTEREST PAYMENTS				
Interest on foreign war debt to United States	160	.....	160	.....
Interest on long term private investments.....	817	252	565	.....
Short term interest and commissions.....	65	107	.....	42
Totals .....	1,042	359	683	.....
TOURIST EXPENDITURES AND IMMIGRANT				
REMITTANCES				
Tourist expenditures .....	168	782	.....	614
Immigrant remittances .....	28	217	.....	189
Totals .....	196	999	.....	803
GOLD BALANCES				
Gold shipments .....	561	169	392	.....
Changes in ear-marked gold.....	68	188	.....	120
Totals .....	629	357	272	.....
Grand Total .....	10,354	10,354	1,874	1,874

From a stock market viewpoint, the chief object of studies in international transactions is to estimate their probable effect upon future gold exports and imports; for gold is the foundation of our credit structure, and credit supplies the fuel for security price movements. Table V brings out quite clearly that gold shipments are by no means dependent solely upon the more readily ascertainable figures of International transactions which are commonly stressed in published discussions.

It is significant that transactions aggregating over 10 billion dollars in 1928 were cleared by the net export of only 392 millions in gold. Even this was partly offset by the net release of 120 millions from ear-marking, so that our net effective loss of gold during the year amounted to only 272 millions. That huge international transactions are settled year after year with relatively insignificant transfers of gold is

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TABLE V  
CONDENSED STATEMENT OF U. S. INTERNATIONAL TRANSACTIONS—  
1927 AND 1928  
(Millions)

	1927				1928			
			Balance				Balance	
	Cr.	Dr.	Plus	Minus	Cr.	Dr.	Plus	Minus
MUCH DISCUSSED ITEMS								
Merchandise exports and imports .....	4,865	4,184	681	.....	5,129	4,091	1,038	.....
War debt payments.....	206	.....	206	.....	210	.....	210	.....
Foreign securities publicly offered in U. S.....	.....	1,481	.....	1,481	.....	1,420	.....	1,420
Gold shipments .....	201	207	.....	6	561	169	392	.....
Changes in ear-marked gold .....	183	23	160	.....	68	188	.....	120
Totals .....	5,455	5,895	.....	440	5,968	5,868	100	.....
IMPORTANT ITEMS, LITTLE DISCUSSED								
Freight charges .....	140	206	.....	66	143	227	.....	84
Refunding operations.....	539	70	469	.....	598	70	528	.....
Open market transactions in securities .....	1,125	740	385	.....	1,845	1,530	315	.....
Interest payments .....	800	281	519	.....	882	359	523	.....
Tourist expenditures .....	163	696	.....	533	168	782	.....	614
Immigrant remittances....	35	241	.....	206	28	217	.....	189
Totals .....	2,802	2,234	568	.....	3,664	3,185	479	.....
ALL OTHER ITEMS								
Totals .....	713	841	.....	128	722	1,301	.....	579
Grand Totals.....	8,970	8,970	568	568	10,354	10,354	479	479

more than mere coincidence. The export or import of a few hundred millions in gold promptly sets in motion a number of counter forces which exert a powerful influence toward reversing the movement. Chief among these is the effect of gold transfers upon interest rates, which rise in the country losing the gold, and soften in the country which imports it. Other considerations being equal, high interest rates attract foreign lenders and repel foreign borrowers, and the resulting flow of funds to the country of high interest rates serves to check the outflow of gold. Our Department of Commerce, in a recent statement, comments upon this as follows:

## New Monetary Influences and the Stock Market

"In recent years there has been a world-wide discussion of the foreign exchange problems of transferring German reparations. From the comparative balances of payments of the United States, it appears that our country has had far larger 'transfer problems' than these and has solved them, usually without being aware that they existed. The forces which create equilibrium in international payments, we must conclude, are more powerful and more various than is usually supposed."

The transfer of reparations payments will constitute a more serious problem for Germany than for any of the other nations individually; although the transactions are bound to exert a profound influence upon economic conditions in Europe during the next half century, and the changes in production and foreign trade thereby brought about will find reflection in our own trade relations, the precise nature of which can not as yet be foreseen. So far as mere cash payments are concerned, our own receipts from this source begin at 210 millions, and gradually rise over a period of about sixty years to a maximum of only 415 million dollars. The German payments, however, begin at 618 millions in 1930 and rise to 957 million dollars in 1965. Altogether our receipts on account of war debt settlements will amount to a little under 21 billion dollars over the next 55 years; and the German payments, if not scaled down in the meantime, will total a little less than 50 billions.

The International Bank of Settlements, which was projected at the recent Reparations Conference to facilitate transfer of these payments, seems destined at this writing to play an even more important role in accelerating the practice of cooperation among international banking executives, which had its beginnings during the past few years in private conferences

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among the heads of leading central banks. Up to the end of the first quarter of the twentieth century, economic laws alone governed the ceaseless ebb and flow of gold between nations. We are apparently bent now upon the experiment of a world wide artificial control of gold transfers, which may lead eventually to a practical elimination of gold shipments and the establishment of an international storehouse for the world's gold, whereby gold balances will be settled by mere book entries, as they are now in this country among the twelve federal reserve districts.

Gold is no longer needed as a circulation medium, and is gradually becoming too valuable to be used for that purpose. If an international institute for gold settlements can be made to function smoothly, the need for gold as a means of settling balances will also disappear. The only remaining monetary use for gold, that of keeping a stiff rein upon the rate of credit expansion, may some day be supplanted by centralized artificial control of credit along lines recently inaugurated by our Federal Reserve Board.

And so it seems to be not wholly impossible that the time may come when gold will no longer be needed for monetary purposes. But this presupposes a long era of universal peace among nations, a development which in turn is being hastened by the growing need for international cooperation in the world's economic and financial activities. In the meantime we are faced with the more immediate probability of a keen international struggle for gold, arising from the fact that demand for the metal is expanding more rapidly than the supply. It is quite possible that the struggle may indeed culminate in abolition of the gold standard, and thus hasten a change that would otherwise have been brought about by slower evolutionary processes.

According to estimates prepared by the Department

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of Commerce, our present status as a creditor nation is neither so important nor secure as is sometimes supposed. The approximate figures, exclusive of war debts, are given in Table VI.

TABLE VI  
ESTIMATED STATUS OF THE U. S. AS A CREDITOR NATION,  
ON JANUARY 1, 1929  
(Millions)

U. S. investments in Latin America.....	4,652 to	5,552
U. S. investments in Europe.....	3,709 to	4,309
U. S. investments in Canada and Newfoundland.....	3,090 to	3,390
U. S. investments in Asia, Australia, and rest of the world	1,104 to	1,304
Total U. S. foreign investments.....	12,555 to	14,555
Less foreign long term capital invested in the U. S.....	4,000	
Less U. S. indebtedness on short term account.....	1,638	5,638
Maximum net credit on capital account.....		8,917

In other words, we appear to be a net creditor nation in an amount less than 9 billion dollars, perhaps even less than 7 billions, exclusive of war debts.

Analysis of the data in Table IV brings out the point that our growth as a creditor nation is dependent upon a number of capital transactions aside from the offerings of foreign securities in the United States. Judged by the latter item alone, our position as a creditor nation was strengthened by the amount of \$1,420,000,000 in 1928. But offsetting transactions—chief among which were foreign purchases of our securities in the open market and refunding operations on an extensive scale—reduced our net increase in the capital credit balance to \$1,011,000,000. It is always possible that foreign open market purchases of our stocks and bonds might increase, and our takings of foreign securities decrease, to such an extent that our present credit balance of a few billions might gradually be pared down, and eventually disappear. Developments along such lines cannot be predicted very far in advance. International transfers of capital depend chiefly upon comparative interest rates,

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and these in turn depend upon the demand for and supply of capital.

It is not even certain that the United States will continue to dominate the international credit market to the extent it has in recent years. We do know that our takings of foreign securities fell off conspicuously during the latter half of 1928, when our interest rates shifted from their previous comparatively low level to one that was comparatively high. At present writing it is generally believed that Europe will secure a lion's share of the forthcoming reparations issue, unless our own interest rates drop considerably before it is offered. Table VII shows that the amount of capital supplied by other nations has been increasing more rapidly during the past few years than that furnished by the United States.

TABLE VII  
FOREIGN CAPITAL OFFERINGS IN THREE LEADING COUNTRIES, 1925-1928  
(Millions)

Year	United States	Great Britain	Netherlands
1925.....	1,330	488	57
1926.....	1,319	593	113
1927.....	1,593	744	136
1928.....	1,488	767	123

### Foreign Exchange

Analyses of international financial transactions and tendencies are of considerable value to far-sighted domestic investors; but the only reliable indication of coming imports or exports of gold is actual shipment or ear-marking of the metal. Premonitory movements in the rate of exchange, however, frequently point days or even weeks in advance to probable transfers. It is therefore of considerable practical value for both traders and investors to know the rudiments of Foreign Exchange.

Foreign Exchange is an order upon a foreign bank

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account, payable in foreign currency: just as domestic exchange is an order upon some domestic bank account, payable in domestic currency. The term includes cable transfers, bankers' drafts, commercial bills, money orders, travelers' checks, bond coupons, and dividend and interest checks. If John Smith in Chicago owes Jim Brown in New York a thousand dollars, Jim Brown can present to his New York bank for collection a draft on John Smith for \$1,000. In the process of collection, Smith's bank account in Chicago will be charged with the amount and Brown's New York account credited; so that, in effect, the domestic draft is an order to transfer a specified number of dollars from one bank account in the United States to another bank account in the same country. Similarly, Sterling exchange is an order to transfer a specified number of English pounds from one British bank account to another bank account in England.

But it may be of no direct benefit to Jim Brown of New York to have a thousand pounds on deposit to his credit in a London bank. He has bills in New York that have to be paid with American dollars. So he sells his right to collect a thousand pounds in England (his Sterling exchange), for its equivalent in American dollars, to someone who can make use of a bank credit of a thousand pounds in England. The purchaser is usually some New York bank or trust company which specializes in buying and selling foreign exchange. The purchasing bank then pays or credits Jim Brown with the proper number of dollars, and forwards the bill of exchange to its correspondent in England for collection and credit to its account there. Subsequently, the purchasing bank will sell a like amount of Sterling exchange to someone who has use for a London credit of an equivalent number of pounds, and thus recover the dollars paid to Jim

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Brown. The second purchaser will forward the bill to London for collection, where it will be charged to the New York bank's account in that city.

*The rate of exchange* is merely the price of a unit of foreign currency, expressed in units of domestic currency. *Par of exchange* is the gold equivalent of a foreign currency unit in terms of domestic currency units. An English sovereign, for example, contains the same amount of pure gold as  $4.86\frac{5}{8}$  United States dollars; so that the par of English exchange in this country is  $\$4.86\frac{5}{8}$ . Mark (German) exchange has a par here of 23.8 cents. Consequently, the par of dollar exchange in Germany is the reciprocal of 0.238—namely, 4.2017 marks.

In this country, the Federal Reserve banks collect domestic exchange, and ship currency, between most points, free of charge; so that domestic checks and drafts on the majority of banks in the country are usually worth their par or face value in any city of the United States. But, as the currency of one nation cannot be used in any other nation, and as considerable expense and delay is entailed in transferring gold from one country to another, it is quite natural that the price of foreign exchange should vary considerably from time to time.

The whole subject of foreign exchange is quite easy to understand if we substitute the words, "deposit," "bank account," or "credit," for the word "exchange." When the demand for foreign credit here exceeds the supply here, the rate of exchange advances. A falling rate of exchange here, say Sterling, indicates that more exchange is being offered here than is wanted at the time. Obviously, a falling rate for Sterling exchange in New York will be accompanied by a corresponding rise in dollar exchange in London; so that the movement may also mean that London is

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in need of more dollar credit in New York than is offered in London at that time. Funds are transferred to a foreign country by purchasing its exchange, and are brought home again by selling the foreign exchange.

Consequently any international transaction which necessitates the movement of funds from a foreign nation to the United States—such as the purchase of our stocks and bonds by foreigners, expansion of brokers' loans here for the account of foreign lenders, collection of payment for our exports, in fact transfers for any of the accounts appearing under column 1 of Table IV—tends to depress the rates for foreign exchange in this country. Any of the transactions listed in the second column of Table IV, on the other hand, calls for transfers of credit from the United States to foreign countries, and hence tends to stiffen the rates here for foreign exchange.

So long as both countries between which such transactions take place are on a gold basis, there are fairly well defined upper and lower limits beyond which the foreign exchange rate can not swing. These are known as the "gold points," beyond which it becomes cheaper to make actual shipment of the metal. The costs of shipping gold include cooperage, carting charges, commissions, freight, insurance, and loss of interest while the metal is in transit. Altogether, these items come to about  $\frac{1}{3}$  of 1% for exports of gold from New York to London. The dollar parity of a pound Sterling is  $\$4.86\frac{5}{8}$ ; but for the purpose of gold shipping calculations a base of  $\$4.872$  is now used, as this corresponds with the Bank of England's present buying rate for gold.  $\frac{1}{3}$  of 1% of  $\$4.872$  is  $\$0.01624$ ; which gives  $\$4.88824$  as the theoretical gold shipment point. In view of the variability of some of the costs, however, it is customary to place

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the point slightly higher—at \$4.88 $\frac{7}{8}$ . Of course these rates apply only to large amounts of, say, a million dollars or more: the charge for both exchange and gold shipments in smaller amounts would be higher. Cable rates for large sums can not rise much above \$4.88 $\frac{7}{8}$ ; because it would be cheaper to establish a London credit by delivering the actual gold to a London bank than to pay a higher rate for cable exchange. The par, and present approximate gold points, for U. S. exchange on six of the more important countries with which we frequently exchange gold, are given in Table VIII.

TABLE VIII  
SIGNIFICANT LEVELS FOR FOREIGN EXCHANGE IN THE U. S.

Country	Par	Approximate Gold Export Point	Approximate Gold Import Point
ENGLAND.....	\$4.86 $\frac{3}{4}$ per sovereign.....	\$4.88 $\frac{7}{8}$	\$4.85 $\frac{1}{4}$
FRANCE.....	3.91 $\frac{3}{4}$ cents per franc.....	3.93 $\frac{3}{4}$ c	3.90 $\frac{3}{4}$ c
HOLLAND.....	40.2 cents per florin.....	40.46c	40.06c
GERMANY.....	23.8 cents per mark.....	23.95c	23.73c
CANADA.....	100 cents per Canadian dollar....	101.7c	99.84c
x-ARGENTINA.....	96.48c per gold peso.....	97.2c	95.8c
x-ARGENTINA.....	42.45c per paper dollar.....	42.77c	42.15c

x-The unit of Argentine currency is the paper dollar, which is normally convertible into the legal standard gold peso at 44% of face value. During periods when the paper dollar is inconvertible, Argentine exchange is quoted in terms of the gold peso.

During the War European nations generally maintained an embargo on gold exports. This made their currency and bank deposits inconvertible, and so demoralized their exchanges that rates in this country fell far below the gold import points. During the present period of grim international competition for gold, many nations are placing restrictions of various kinds upon the export of gold to the United States; so that their exchanges have had to drop appreciably below the theoretical gold import points before gold began to flow outward. At present writing, for example, we are drawing gold from England with Sterl-

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ing cables at 4.847 $\frac{7}{8}$ , Argentine gold is coming in with the paper dollars quoted at 42.08, while Canada sees her exchange at 99.09 without losing gold to us. One of the curious paradoxes of the situation is that our Federal Reserve Board welcomes these restrictions upon the release of foreign gold; but holds interest rates in the New York money market at such high levels that gold is drawn to us by an almost irresistible attraction. At present writing, gold reserves of the Bank of England are again approaching the Cunliffe minimum of 150 million pounds below which, according to tradition, it must not be permitted to fall, and there is talk that the Bank will for the second time this year be compelled to raise its discount rate. Ninety-day time money in New York has just dropped to 7 $\frac{1}{2}$ %, however (thanks largely to our recent accretions of foreign gold), from a maximum of 9 $\frac{1}{2}$ % touched earlier in the year; which points to the possibility that our money market may ease off opportunely, and thus avert the threatened vicious circle of competitive increases in national discount rates—for the time being, at least.

Central banks in a number of foreign countries deal in foreign exchange on a large scale, partly because holdings of foreign exchange are now included with gold as cover for their circulation, and partly because such transactions may be utilized to steady their own exchange. If francs in New York are now down near the point where we are likely to draw gold from France, the Bank of France can sell dollar exchange in Paris, and thereby support French exchange and protect its gold reserves. The reason for this becomes clearer when it is recalled that many banks include under the term, "foreign exchange," not only foreign bill holdings but also foreign deposits.

Another practice that has been coming rapidly into

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favor among central banks since the War is to keep part of their own gold reserves in the custody of central banks in other countries. For example: France will buy gold from our Federal Reserve banks but, instead of bringing it across the water, will arrange to have it stored here in Federal Reserve vaults, subject to her instructions. This is reported by the Federal Reserve board as "ear-marked" gold, without mentioning the nation for which the gold was ear-marked. In bank statements of the following week, the transaction will appear as a deduction from the gold reserve of our Federal Reserve banks, and an addition to reserves of the Bank of France. Subsequently, the bank of France may sell this gold back to us, and it will then be reported here as gold "released from ear-mark," and added to our gold reserves.

So far as the effects upon our money market are concerned, ear-marked gold is tantamount to an actual export of the metal, and gold released from ear-marking is equivalent to gold imported. But ear-marking transactions reduce gold movements to mere book-keeping entries, analogous to the method by which domestic transfers are cleared through the Federal Reserve System's gold settlement fund in Washington. Maintenance of a gold reserve abroad, moreover, enables a central bank to exercise closer control over its exchange. The spread between gold points is made smaller through elimination of various shipping charges, and the element of risk is reduced to a minimum. The practise is one of the products of growing cooperation among central banks.

### Domestic Developments

Though international influences, such as gold movements and world wide competition in the production

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of basic commodities, have been contributing factors in the phenomenal prosperity this country has experienced since 1921, a number of domestic developments, new in degree if not in kind, have made the years between 1921 and 1929 stand out in sharp contrast with all earlier prosperous periods. As pointed out in the recent report of the President's Committee on Recent Economic Changes, "Acceleration rather than structural change is the key to an understanding of our recent economic developments. . . . Invention is not a new art. Transportation and communication are not new services. The facilitating function of finance is older than coined currency. Agriculture is as ancient as history. Competition is not a new phenomenon. None of the changes in distribution on which emphasis has been laid in the last few years is basically new. Hand-to-mouth buying is old; sudden changes in style and demand are familiar; there is no new principle in installment selling; cooperative marketing is no modern discovery; the chain-store movement dates back at least 25 years. But the breadth and scale and 'tempo' of recent developments give them their importance."

Aside from the enormous amount of credit that was released by our Federal Reserve Act, the next factor in importance has been the growing spread between wages and the cost of living. On this point the President's Committee remarks: "The widening gap between wages and the cost of living—wages increasing while the cost of living was stationary—may be assumed to have contributed definitely to the degree of prosperity which has characterized the period as a whole. With rising wages and relatively stable prices (see accompanying graph) we have become consumers of what we produce to an extent never before realized."

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This change from a "living wage" to what has been termed a "cultural wage," is largely responsible for the democratization of leisure, comforts, and investments, and promises to have far reaching effects henceforth upon the demand for goods and securities. Other changes of less sweeping character individually, but of great importance in their cumulative effects, have been the progressive shortening of the work day and week; the growing productivity of labor arising from widespread introduction of improved machinery; the increasing number of women in industry, and lessening of their labor in the home by modern conveniences; the rapid increase in popular and technical education; restrictive immigration; the release of considerable capital and labor formerly employed in the liquor industry; greater average longevity and reduction in the birth rate, which have combined to increase the proportion of our population which is of employable age. The latter transformation has taken place so gradually that its significance has scarcely been noted. In summarizing the facts in Table IX we have emphasized the economic significance of this shift in the age composition of our population by noting that we are all dependents from birth to death.

TABLE IX  
A HALF-CENTURY'S CHANGE IN THE AGE COMPOSITION  
OF OUR POPULATION

Age Group	% of Total Population	
	1870	1920
Under 20—Age of dependence upon parents.....	49.7	40.7
20 to 49—Age of dependence upon work.....	39.4	43.5
Over 49—Age of dependence upon investments.....	10.8	15.4
Unclassified .....	0.1	0.4

Dividing lines between the three ages of dependency are, of course, drawn arbitrarily in Table IX. The arrangement allows 20 years for growth and ordinary education, 30 years for work and saving, and

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the years from 50 onward to be passed in financial independence. In actual fact there will always be much overlapping in activities—people work and have income from investments at all ages—but the classification serves at least to bring out quite clearly that no small part of our gain in material wealth during the past half century may be attributed to the diminishing proportion of dependent minors. In 1870 each adult supported one minor: fifty years later this burden had been reduced by 33%. The marked tendency toward increased leisure is evidenced by the fact that only 37.2% of our population was gainfully employed in 1925 as against 41.5% fifteen years earlier, despite the entrance of women into industry.

### Credit Expansion

That eight years of growing prosperity, unbroken by major recessions, should have been accompanied by rapid expansion in bank credit was quite to be expected. What chiefly distinguishes the present upswing from other similar periods is the relatively small increase in commercial loans, and the large amount of non-banking credit which has been drawn into the security markets. The two phenomena are not unrelated. During the War many of our larger corporations accumulated huge surpluses which have since been only partially distributed to stockholders. During the past eight years corporate holdings of cash and marketable securities have more than doubled. Had the present period of industrial prosperity been accompanied by the customary inflation in commodity prices a much larger amount of cash and credit, both banking and corporate, would have been absorbed by demands from commerce and industry. But with commodity prices stationary to soft, great quantities of accumulating credit and liquid cap-

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ital, which otherwise would have remained idle, have sought employment in the securities markets.

As a result of such conditions we have witnessed of recent years an unusually rapid expansion in brokers' loans and in corporate holdings of investment securities. This development has been accelerated by the ease with which corporations have been able to finance their working capital requirements through the sale of securities. During the past year, especially, it has been much more profitable for corporations to finance their needs for current funds through sales of common stock than to seek credit at the banks. Funds realized from the sale of new securities have been loaned out on call at highly remunerative rates (in some instances at higher rates than the company could earn by investing the money in its own business) and these loans have helped the market to carry their new issues while the floating supply was being gradually absorbed by the ultimate investor. A third factor which has helped to sustain and stabilize this prolonged bull market has been the rapid growth in individual bank deposits, which has not only supplied private investors with the funds to go on buying stocks at ever increasing prices but has enabled them to meet the rising margin standards of late years demanded by brokers.

### Federal Reserve Policies

That a bull market could go on for eight years without terminating in a crash has confounded many economists and discredited many prophets of disaster. They have failed to perceive that the market is now under the control of conditions which, if not new in kind, are vastly different in degree from those which have obtained in previous bull markets. Bull markets of the past have been fed almost exclusively upon

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bank credit, and have had to compete for this credit with the rapidly rising demands of commerce and industry. In the present bull market, these latter demands have not grown excessively, and the stock market has itself supplied a large portion of the funds needed to finance it.

This is a situation which even the Federal Reserve Board seemingly failed to perceive clearly at the time of embarking upon its crusade to check the rate of growth in brokers' loans. A few quoted references to official explanations of the Board's policies tend to support this surmise.

In the fourteenth annual report of the Federal Reserve Bank of New York occurs this paragraph: "It became clear early in 1928 that the growth in the volume of credit was far oustripping ordinary commercial and industrial credit requirements. Many years of experience have shown that increases in credit beyond business needs lead ordinarily to unfortunate results, to speculative excesses, to price increases, to booms which end in depressions. It has, therefore, become the prudent practice of banks of issue to subject extraordinary increases in the use of credit to the test of higher interest rates."

In fairness to the Federal Reserve Board, investors should recall that it was guided by the same aversion to speculation in commodities when, in 1920, it precipitated the memorable liquidation in frozen inventories. That its fears were justified in 1920, but not in 1928, points to the need for some revision of the theories by which the Board's policies are governed. As one spokesman for the Board has pointed out, if there is inherent weakness in the situation it will become manifest when subjected to the test of high interest rates. In 1921, both industry and the stock market collapsed under the test: in 1929, high interest

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rates, though reenforced by other restrictive measures, have failed up to this writing to disclose any fundamental weakness in either the stock market or the business structure as a whole.

It is true that high interest rates have caused some slackening in speculative building activities, owing to the difficulty of selling construction bonds and in raising second mortgage money; and higher carrying charges may have hastened somewhat an inevitable liquidation in the wheat markets; but aside from these minor weak spots, commerce and industry still maintain a rate of activity which is abnormally high for this season of the year.

As to the stock market, reactions which have been attributed to Federal Reserve restrictions upon call loans have probably been less severe, in proportion to the average price level, than those that have occurred in former bull markets. There have been, to be sure, quite extensive declines in specialties which had been overmanipulated by weak pools; but the higher grade issues snapped back quickly after each reaction, and are now making new high records.

There has been a great deal of ill informed argument as to whether the Federal Reserve Board's restrictive efforts have proved successful. Much of the criticism has arisen from failure to comprehend clearly what the Board undertook to accomplish. The circumstances which led the Board to take restrictive

TABLE X  
GROWTH OF LOANS BY WEEKLY REPORTING MEMBER BANKS—1926-1929  
(Millions)

End of May	Loans on Securities		Commercial Loans	
	Total	Increase	Total	Increase
1926.....	5,409		8,394	
1927.....	5,831	422	8,659	265
1928.....	6,889	1,058	8,882	223
1929.....	7,102	213	9,100	218

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action, and the effectiveness of such measures, appear clearly in Table X.

In view of the Board's conviction, whether well founded or not in this instance, that any abnormally rapid expansion in bank credit "leads ordinarily to unfortunate results," there was ample provocation for precautionary measures in the billion-dollar expansion in security loans for the year ended June 1, 1928. That the restrictive measures were successful in checking the tendency is evidenced by the moderate increase of only 213 millions during the following year. The board has been berated and even ridiculed for asserting that it is not its purpose to control stock market prices. Yet, at present writing, when the episode is about to pass into history, people of calm judgment are beginning to admit that Charles S. Hamlin, member of the Federal Reserve Board, was supported by the facts when he stated in a recent address: "The Federal Reserve System has taken an effective control of the situation without increasing discount rates, and in the control thus exercised through the medium of direct pressure the system has established a new technique which shows that diversion of Federal Reserve credit into speculative channels may be curbed without serious injury to agriculture and business." And, he might have added, without injury to any investor who selects his securities on the basis of intrinsic values.

But it is important for traders and investors to keep constantly in mind that no situation in the money market is ever settled permanently. New conditions are continually arising to tax the judgment of both investors and the central bank executives who are charged with the responsibility of guiding the world's credit policies. In the long run, economic forces determine the distribution of gold and credit; but the tempo, and even

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the direction, of these broader movements can be altered temporarily by central banking policies. W. Randolph Burgess, assistant Federal Reserve agent in New York, points out in this connection that: "High money rates tend to draw funds from all over the world; low money rates tend to repel gold and encourage the use of credit and thus lead in turn to higher rates. Thus *any policy sets in motion the very tendencies which will nullify it in the long run.*"

### Loans for Others

In Chapter VI we shall have more to say about this important subject; but it seems appropriate here to call attention to several characteristics of "Loans for others" which are not generally well understood.

A great deal of confusion as to the influence which loans for others exert upon the money market may be traced to the ill advised practice of including them with bank loans under the general caption of "Brokers' loans." When a commercial bank makes a loan for its own account, a new deposit is created, against which a legal reserve must be carried with the Federal Reserve Bank. When corporate and other non-banking funds are loaned to brokers, an existing deposit is merely transferred from one bank to another; so that total deposits, and hence the amount of reserve required against deposits, remain unaltered. Thus we find that the enormous growth in brokers' loans for the account of others, which is probably the most prominent development of the present "new era," has facilitated, without strain upon the money market, an expansion in our security markets which would not have been possible had the "Street" been solely dependent upon bank credit.

But, while the *expansion* in loans for others has exerted no direct strain upon the money market, it does

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not seem reasonable to view the consequences of possible *contraction* in these loans too complacently. The fourteenth annual report of the Federal Reserve Bank of New York comments upon one aspect of this problem as follows:

"From the point of view of their effect upon the credit structure these loans by others require careful scrutiny because they are a potential charge against bank reserves although they are largely outside of the control of the banking organization. The manner in which these loans may, in fact, become a charge against bank reserves was illustrated by occurrences over the year-end (of 1928). As the year drew to a close a considerable number of corporations and others began to withdraw funds from the market probably for "window dressing" purposes. Such withdrawals for foreign accounts were evidenced by a considerable strengthening in a number of European exchanges which was followed after the first of the year by a weakening as the funds were returned to this market. There was also a considerable transfer of funds from New York to other districts in the United States. Altogether, withdrawals of this sort from the call loan market for accounts other than banks totaled close to \$300,000,000, and for out-of-town banks were over \$200,000,000, so that New York banks were called upon to put into the market nearly \$600,000,000 of their own funds to replace the funds drawn out. This increased both the loans and deposits of the New York City banks and consequently their reserve requirements, compelling them to borrow heavily from the Federal Reserve Bank. The possibility of such withdrawals and their replacement by bank loans makes it prudent to consider these loans as a potential charge against the country's basic bank reserves."

Ordinarily, this periodic tightening in call rates at

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the end of the year and mid-year causes no serious reaction in the stock market, because traders well know that the condition is merely temporary. In time, as our bankers become more reconciled to the existence of loans for others, it should be possible to attack the problem of this seasonal squeeze in money with due regard for the facts, instead of handing out Sunday school cards to the good corporations who protect their stockholders from the bootlegging profits that are temptingly offered in the naughty call market. When and if we ever reach the Utopian era of unabashed frankness in corporation reports, much of the year-end embarrassment may be avoided by dressing the balance sheet window with "Cash and call loans," instead of pure "Cash." Many pagan corporations have the hardihood to do this even now.

But, while the problem of *seasonal* withdrawals from the call market seems possible of solution, we have little or no experience to guide us in predicting the consequences of a *permanent*, even though gradual, withdrawal of funds loaned by "others." Originally these outside funds were drawn into the call market by rising interest rates. It seems reasonable to suppose that falling interest rates would cause a considerable portion of such funds to be withdrawn; but, unless the withdrawals were made gradually or during a period of extensive liquidation in the stock market, commercial banks would have to take over the loans called by outsiders and this would cause a rise in interest rates. Thus it seems that the huge reservoir of outside funds has not only served to postpone until the second half of 1928 a rise in interest rates that would otherwise have taken place several years earlier, but is also likely to retard a much to be desired return of interest rates to more normal levels.

## CHAPTER VI

### Market Manipulation Under New Conditions

**T**HE stock market has now become such a huge affair that it can no longer be manipulated as a whole, unless perhaps through manipulation of the money market. Even then, an increasing number of stocks move counter to the main tide. In earlier years there was a more pronounced tendency for all stocks to move simultaneously in the same direction. As the number of issues listed grows, our own market is rapidly acquiring the characteristics of the London stock market, which moves in groups more often than as a whole.

#### Group Movements

There are now three quite clearly defined types of group movements in the market, which traders and spec-vestors will find it profitable to study. These are the Industrial groups, Banking groups, and Price groups. Some commentators would add a fourth, the Prominent Market Operator groups, each of which includes issues sponsored by some prominent market operator. If, for example, a well-known operator such as Arthur Cutten is reported to be active in the market, the public will tend to buy stocks in which he is supposed to be interested, and so these may all move together in the same direction. This type of movement is likely to dwindle gradually in importance as the market goes on broadening until its great size and

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complexity overshadows the activities of any one personality.

Industrial group movements, however, will probably become a more conspicuous feature of future markets. These are motivated by changing conditions and prospects in single industries and, like the stock market, business and industrial activity no longer presents a united front as it once did. This is because, under Federal Reserve regime, we are no longer confronted with periodic acute shortage of funds for commercial purposes, and this frees each industry to respond to its own economic influences. And so now we have days and even weeks when activity in the stock market is confined largely to the public utilities, or the railroads, or the oils, or copper stocks, etc.

Toward the apex of a spec-vestment cycle, when the public is overloaded with stocks, brokers' loans are making new high records, interest rates on stock exchange collateral are high, and banks and brokers are demanding stiffer margins, a survival of the old effort to manipulate the market as a whole is still to be observed in the rapidity with which first one industrial group and then another is made prominent while distribution is going on in other sections of the list. This rapid shifting in activity from one industrial group to another is typical of the culmination of a long upward movement in the Combined Average.

### Sponsorship

This is a subject which all experienced traders and investors consider first in selecting their commitments, because the market career of a stock is intimately dependent upon its sponsorship. Sponsorship is of three kinds; market sponsorship, company management, and banking affiliations.

## Market Manipulation Under New Conditions

One of the best assets a stock can have is a close market, so that buyers and sellers can trade in it freely without causing wide fluctuations in price. This is a thing quite apart from capable corporate management. Without strong market sponsorship, a stock finds little favor with either speculators or investors. It requires strong market leadership, too, to put a stock up. Many stocks remain underpriced for long periods, for lack of the necessary organized buying to bring them into line with intrinsic values. It is here that vigorous bull pools, with strong financial backing, frequently render service of inestimable value to both traders and investors.

Management is often the deciding factor in determining which company obtains a lion's share of profits in the competitive struggle within an industry. And market prices for a company's stock will always be governed, in the long run, by per-share earnings and the rate at which they increase.

Strong banking affiliations are of great value to a corporation; partly because it insures that the management will be well chosen and that the company's financial requirements will be skilfully, economically, and adequately handled, and partly because it leads to advantageous business connections with other companies which the banking group is also sponsoring.

The recognized importance of financial sponsorship sometimes leads to extensive group movements among stocks known to be sponsored by certain leading banking groups; because a bank which is sponsoring the industrial operations of a company usually takes an active interest also in the stock's market career. When the Morgan stocks, or the Baker stocks, for example, are strong, people are likely to infer that the whole market is destined ultimately for higher prices on account of the strong character of the leadership. But

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here too there is a noticeable tendency for stocks to break away from considerations of mere personality and to respond more and more to financial and industrial fundamentals. There was a time, not so many years ago, when strength in Steel was almost certain to be accompanied by strength in General Motors, Fleischmann, Harvester and a number of other issues which have come to be known as Morgan stocks; but traders who are familiar with the character of recent markets will confirm the observation that the Morgan stocks listed in Table I no longer move as a group.

TABLE I  
A FEW OF THE "MORGAN STOCKS"

<i>Rails</i>	<i>Industrials</i>
Atchison	Assoc. Dry Goods
Atl. Coast Line	Cerro de Pasco
Chesapeake & Ohio	Congoleum-Nairn
Chic. Gt. Western	Continental (formerly Marland) Oil
Erie	Fleischmann
Great Northern	Gen. Electric
Louisville & Nashville	Gen. Motors
New Haven	Int. Agr. Chemical
New York Central	Int. Harvester
N. Y., Chic. & St. L.	Int. Merc. Marine
Northern Pacific	Int. Tel. & Tel.
Pere Marquette	Kennecott
Reading	Nev. Cons. Copper
Southern Railway	Pullman
	Tex. Gulf Sulph.
	U. S. Steel

A few other groups commonly identified with prominent banking houses are:

### *Kuhn, Loeb & Co., Stocks—*

Amer. International, Chic., Mil., St. Paul & Pac., Delaware & Hudson, Illinois Central, Missouri Pacific, Penn. R. R., Southern Pac., Union Pac., Wabash, Western Union, Westinghouse Mfg., Youngstown Sheet & Tube.

### *First National Bank (Baker) Stocks—*

American Can, Amer. Tel. & Tel., Baltimore & Ohio, Del., Lack. & Western, Erie R. R., Nat. Biscuit, Pullman, U. S. Rubber.

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### *Goldman-Sachs Stocks—*

Amer. Metals, Cluett, Peabody, Cont. Can, Endicott-Johnson, Kelly-Springfield, Lehn & Fink, R. H. Macy, Nat. Dairy Prods., Sears, Roebuck, Studebaker, Woolworth.

### *Dillon, Read Stocks—*

Amerada, Am. & For. Power, Commercial Inv. Trust, Chrysler, Fisk Tire, Goodyear Tire & Rubber, Loew's, Nat. Cash Register, Seaboard Air Line.

It will be noted that a few of the larger companies are identified with more than one banking group.

## Price Group Movements

As a general rule it may be observed that high priced stocks, as a group, lead the broad upward movements in the general market and are followed some time later by medium and then low-priced stocks. When it comes to a major reaction, low-priced and over-manipulated stocks that have been bulled by the public or by insecurely financed pools are frequently the first to give way, while the high priced stocks resist longest. Big operators naturally favor the issues of companies with large capitalization, because they can swing large blocks of such stock without unduly influencing its market price. These stocks are usually high in price because their earnings increase continually at a more rapid rate than the stock can be reduced by stock dividends and split-ups.

After the high priced stocks have been advancing for awhile, the public begins to acquire confidence, for it is recognized that influential operators who are engineering the movement have exceptional facilities for knowing what they are doing. With smaller funds at its disposal, the general public tends to select the lower priced stocks as an outlet for its enthusiasm,

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because more shares can be bought for a limited amount of money. But a comparatively small amount of buying produces a proportionately greater advance in low priced than in high priced stocks. It is, indeed, a well-known fact that low priced stocks fluctuate over a much greater percentage range than the high priced stocks.

Now the low priced stocks, as a class, are low in price frequently because the companies which they represent have been going backward, or at least standing still, in the competitive struggle for business. Consequently any large and sudden advance in price soon brings them to a point where they are obviously overpriced, even in the judgment of inexperienced observers. This leads to rather hasty profit taking; and the resulting decline is further accelerated by influences, such as rising interest rates, admonitions from banking and brokerage quarters, and the raising of margin requirements, which eventually precipitate a reaction in the entire market. Wealthy operators are able to hold out longer than the general public against these adverse influences—partly because they have had more experience in the business, and partly because they enjoy superior credit facilities in addition to their own large resources.

### Altered Character of Manipulation

Now that the market is breaking up into group movements, manipulators of individual stocks who formerly relied upon strength in the general market as a whole to assist them in marking up their favorites must now wait for strength in the special group of related stocks. A pool that is accumulating Chrysler Motors, for example, will find little assistance now from strength in the Steel group, or in Public Utilities, etc.: it knows that little progress can be made in

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marking up Chrysler, until other leading Automobile stocks also take on strength. To mark up Chrysler when other motor stocks are declining or stationary would simply invite a flood of offerings from outside holders.

Another characteristic of recent manipulative activities, which has at times proved puzzling even to experienced observers, has been the frequency with which some new pool would take stock thrown on the market by a former pool that was cashing in profits. This is one of several reasons why the orthodox secondary reaction, which traders always looked for in former bull markets, frequently failed to appear after drastic shake-outs of the past two years. Investment trust buying, rapid growth in "loans for others," and the exceptionally strong cash position of margin accounts, have also been instrumental in eliminating secondary reactions.

In the days of five and ten point margins, technical reactions usually left in their wake a number of crippled margin accounts that had to be taken over by bankers and brokers, and it was liquidation of these accounts on the first rally after the shake-out, that caused the typical secondary reaction. With margin requirements now up to thirty or forty per cent of market prices, and with most customers carrying secondary reserves of ample cash in the bank, technical reactions in the market do little permanent damage to anyone.

But this new state of affairs makes it more difficult for even trained readers of the technical position to recognize the bottom of a reaction. The turning point usually comes without notice, and the averages go on climbing again, day after day, and week after week, and many stocks soon begin making new high records again as though there had never been a set back.

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### A Resilient Market

Every important technical situation that develops in the market is paralleled by some economic cause. The phenomenal resiliency of the 1928 bull market was a natural response to the unusual rate at which earnings were increasing. A compilation made by the National City Bank of New York shows, indeed, that the net earnings of 527 leading manufacturing and mercantile companies rose 21.6 per cent in 1928. And so it need occasion little surprise that institutions, investment trusts, corporations, and private investors all welcomed reactions as opportunities to add to their holdings of high grade common stocks.

But this is far from saying that any amateur could make money in the great bull market of 1928. Among individual stocks there were many cross currents, and it has been the rule rather than the exception, of recent years, for a primary bear market to be slashing prices in some sections of the list while bull markets raged in other groups. The net result, to be sure, was a great rise in the general averages; yet the market of recent years has differed from all others in the degree to which it has been self-correcting. A number of stocks have suffered as severe declines as they used to in old-fashioned bear markets.

Standard issues of companies whose earnings go on increasing from year to year, on the other hand, have rebounded quickly after every technical reaction; for the amount of reserve purchasing power waiting to pick up such stocks on reactions is greater than Wall Street has ever before known. Corporations, which already own more than a fifth of all stocks outstanding in this country; investment trusts now capitalized at over a billion; wealthy individuals with 40 per cent of their investments consisting of stocks; fire and

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casualty insurance companies with over 40 per cent of their investments in stocks; are continually accumulating surplus funds which seek employment in the stock market either through brokers' loans for "others" or through outright purchase of securities.

### Stabilizing Influence of Loans for "Others"

Along with a number of stabilizing influences that have smoothed the bumps out of our price curve during the past eight years, must be included that of loans for "others." These loans represent surplus funds which, in other days, would have been invested mostly in securities. So long as call rates remain high, the funds are now put to work in the call market where they assist others to purchase stocks; but, when call rates decline after any important reaction in the stock market, a portion of such funds which are no longer demanded in the call market are withdrawn and used to purchase stocks at bargain levels. As prices recover, some of the stock comes back upon the market, thereby releasing funds again needed in the call market. And so, by this process, the much denounced "loans for others" really perform the useful functions of an automatic regulator for both stock and call markets.



## Part II

### What and When to Buy



## CHAPTER VII

### Investment Trusts and How to Judge Them

THE Investment Trust or Investment Corporation, as most of such enterprises are now organized, had its origin in Scotland about 1860. It probably resulted from the successful administration of large estates by capable attorneys pending their division among the heirs. Legal trusts still contain a provision for termination at a definite date and are hedged about with many restrictions.

The Scottish and English investment trusts had certain definite characteristics. Their basic policy was the conservation of an investment fund. Their method was to invest this fund in bonds and preferred stocks for income and in common stocks for income and appreciation of principal over a period of time. They specialized in foreign issues. Only a small fraction of the fund was invested in any one security. The investments were also diversified geographically and according to industries. Securities were purchased, held or sold at the discretion of their boards of directors under the terms of their charters which often contained comprehensive and detailed restrictions. Short selling and margin trading was forbidden.

Their own financial set-ups usually included both preferred and common stocks and often bonds to meet the requirements of various types of investors. These were, in type, what are now known as general management trusts. They developed over a long period during which many fell by the wayside while others,

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well managed, made an outstanding record in the new field. In the seventy odd years of their history, they grew in numbers to about 150 and in resources to over \$1,000,000,000.

### The Start in America

Only two investment trusts are reported to have existed in the United States before 1900, one, the Boston Personal Property Trust formed in 1893, being still active. In 1904, Railway and Light Securities Company, which also is active, was organized, in 1907 the Alexander Fund, in 1920 the Overseas Securities Corporation and in 1921 the International Securities Trust. By 1924, some fifteen such companies were in operation with total assets of some \$14,000,000. Today, it is estimated that over 400 investment companies and allied enterprises with total assets approaching \$3,000,000,000 or more exist in this country with more being launched every month.

The early American investment trusts or companies were of a personal or semi-private character known only to small groups and with no aggressive sales program.

The International Securities Trust (now a corporation) modeled upon the Scottish-English general management type pursued a different policy. It offered its securities to the public, built up a dealer organization, and grew from its chartering in 1921 to an institution of some \$69,000,000 in resources by November 1928. The success of this company inspired the organization of a veritable tidal wave of investment companies, fixed trusts, trading, holding and finance companies all offering the investing public varied and enticing inducements for the use of its surplus funds.

The fixed trust differs from the general manage-

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ment type in that blocks of securities, usually common stocks of well known companies, are purchased for permanent holding by the trustees and certificates of beneficial interest issued representing a proportional share in the trust's assets. The management factor after the original selection is once made therefore is absent and the price of the certificates fluctuates directly with those of the stocks selected.

Criticism of the rigidity of the portfolio of such trusts and lack of popularity led to the adoption of a modified form of fixed trust called semi-fixed trusts.

In these types, security holdings are also bought for permanent investment, but substitutions for good cause may be made by the trustees. Such trusts give the small investor the advantage of diversified risk for his investment in a list of securities which are always before his eyes. On the other hand, they do not by their nature enjoy the protection from loss, or the opportunities for profit obtained by the general management type through the continuous control exercised by its management.

The financial trading company is similar to the general management type in organization, but usually possesses much broader powers and pursues an avowedly more speculative policy, purchases and sales and short sales being entirely at the discretion of the managers without restriction, diversification and permanent holdings for long term profits not being emphasized. Its primary object is to make quick profits by in and out trading, by purely stock market operations similar to those of stock pools and by a varied series of marketing deals such as taking over and disposing of large blocks of stocks from estates or assisting in merger or financing transactions. It engages in the most speculative and hazardous branch of the investment field and while capable of produc-

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ing large profits, if honestly and shrewdly managed, is also subject to great losses and dangerous entanglements especially in hands not so skillful and there are few real experts in this specialty. It is the operations of this type that has caused the phrase "blind pool" to be applied to investment trusts generally, few of which, of course, deserve it.

The holding company, as its name implies, is empowered to control and manage other companies as well as to purchase diversified securities for investment, or to trade in the market. It usually specializes in one field such as power and light, insurance, banking or mining. The holding company is an old form of corporate organization in this country compared with the other types and has been signally successful in the building up of many industries, most notably in the public utility field. It controls, supervises and finances its subsidiaries and profits correspondingly from their growth. The nature of its work commands the highest grade of investment and business talent.

The finance company, also as implied by its name, specialized in the long term financing of business corporations usually acquiring a large, or even controlling interest in their stock for its services. It is investment banking and holding company work combined without necessarily specializing in any particular field. Like the holding and trading company, it possesses broad powers, great profit opportunities as a reward for ability and hard work and also opportunities for loss commensurate with the skill and foresight with which it is administered.

### Investor's Standard

Confronted by these diverse types of investment and financial companies the investor can be pardoned a high degree of confusion as to which company best

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meets his needs and desires. The solution, however, is not so complicated as it appears at first sight. Experience has shown that in practice these diverse types blend into each other to an astonishing degree. A trading company, in practice, may become a staid, long term investment holding fund. A general management trust may evolve into a reckless trading company, or if its charter permits, may become specialized. Holding companies become investment trusts and companies originally formed to operate in one industry become general management types and so on. It is also a matter of record that the most rigid, practicable restrictions will not protect the investor from dishonest, or incapable management, or the absence of all restrictions prevent him from profiting from management of ability and integrity.

*Consequently, it follows without question that the first and decisive consideration of the investor in the financial industry should be not the type of organization but the personnel of the responsible management of the company to which he contemplates entrusting his hard earned money. Who are They? What is their record? What of their reputation? If the investor does not know this and cannot get satisfactory information, it is only common sense to disregard glowing predictions and to look elsewhere. Management is a particularly important factor in investment companies because the assets of such companies are almost exclusively cash, call loans and marketable securities and because the business of such companies is the investment and reinvestment of these assets, shifting them as seems best from company to company and from industry to industry. Such assets are easily converted to personal enrichment by dishonest managers and can be easily, quickly and secretly dissipated by incapable and reckless managers.*

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There are certain well defined tests of good management which can be made by every intelligent investor and will be made by every cautious one. The most important perhaps is the past record of achievement and the reputation resulting from it. At the end of 1925, there were 48 investment companies in the United States with a total capital of some \$150,000,000 and at the end of 1927 there were 150 such companies with some \$700,000,000 of capital. The records of these have become well known. Most of them are limited, some rigidly, by their charters to minority ownership in other companies, but a few have the broader powers commonly accorded to a holding company.

Investment companies formed since the close of 1927 have had a relatively short period in which to make an earning record, and of course the flock of 1929 "trusts," some of immense size, offer little in this respect. Yet their stocks have been popular and in many cases decidedly profitable. This is due to the record and reputation of their managers in other allied fields. It is estimated that some 60% of investment companies are managed by partners of investment banking and stock exchange firms and another 10% affiliated with banks and trust companies, this group including most of the larger ones. A few large, well known "trusts" are managed by professional investment company managers, or independent investment counselors though the trend seems to be for these also to establish investment banking or stock exchange affiliations or to become, themselves, investment bankers. The balance of about 25% to 30% appears to be controlled and managed by individuals not partners of important financial institutions. Many of these also have attained considerable success, but necessarily operate in a more restricted field.

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### Successful Sponsorship

Many, if not all, of the investment banking and New York Stock Exchange firms sponsoring investment companies have established enviable reputations for integrity and ability and find an eager clientele and general following ready to engage in the joint investment enterprises which they propose. Many of the partners of these firms have successfully operated private investment accounts of their own from the profits of which the public has heretofore been excluded, organized as they were on an unlimited liability basis. As a group, they probably constitute the highest investment talent available and probably possess the greatest opportunities for securing reliable information about the manifold, daily happenings in the investment and speculative world.

The average investor may know in a general way that such and such a firm, or man, is "good" without having any very definite information as the basis of his opinion. The flotation of an investment company by such a firm gives the public an easy way of checking the favorable or unfavorable reports that may have reached it. Obviously, any group of partners who can quickly raise \$10,000,000, or more, to be invested according to their own discretion are entitled to serious consideration. The figure mentioned might even be lowered to \$5,000,000, or \$1,000,000 or less according to circumstances but \$10,000,000 has been chosen because there are easily forty to fifty American investment companies having assets of over that amount and exhibiting all the variations in powers, policy and financial set-up that need be discussed for an understanding of investment "trust" appraisal factors. The amount of capital contributed by the public and the time required is an important indication of

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the standing of the organizers among those who know them best.

Assuming, therefore, that we are dealing only with investment companies with preponderant claims to countrywide appraisal, what additional facts should the careful investor seek? An important point is the time and labor the managers expect to devote to the work of management. It may, or may not, be their major interest. Some light may be thrown on this question by the amount and proportion of their own permanent cash investment in the joint undertaking. Among forty large American investment companies, the cash contribution of the organizers and management ranges from the nominal organization expense or price of directors qualifying shares to as much as 75% of the capital. Only three companies show an investment on the part of the organizers of over 50% of the total capital. Ten of them show a sponsor and/or management investment of 20%, or more as originally organized. Fourteen show a management, or sponsors' investment either in the original or subsequent capitalization of less than 5% of the total capital. A ruling of the California Corporation Commission requires that 20% of the capital be paid in by organizers of investment "trusts" in that state.

Undue weight should not, however, be given to this factor, for experience has shown that reputable and able management can be obtained without a heavy management investment. It is only one thing among various others to be considered. Its chief significance is in serving as a material guarantee against lack of due diligence in avoiding losses on the part of the controlling interests. Where no or only a nominal investment is made by the management, the theory is that of numerous partnerships wherein one partner contributes the capital, the other the experience and

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labor, and both share more or less equally in the profits.

### Management Options

For obtaining due diligence and maximum effort from the managers, it is apparent that the main reliance of investors is upon the intangible qualities of conscientiousness, and pride of achievement of the controlling interests and/or managers and the material compensation accruing to them. The terms of the latter can be ascertained immediately. Of the companies studied, organizers and managers of some 21 receive 50%, or more, of the common stock. The amount of common received ranges in the group from none to 83%. Where no common stock is obtained by the controlling interests, or managers, compensation is usually in the form of options to purchase common stock at a later date, or by a fixed periodical percentage of the capital, or a fixed periodical percentage of the net income. In six cases where no common is received, options acquired range from 33 1/3% of the outstanding common to 100% with various terms for their exercise. In five cases, options are received ranging from 17 1/4% to 112% of outstanding stock where substantial amounts of common are also obtained. In one instance, the organizers for 20% of the investment receive 60% of the common and options to purchase 100% of the issued common shares. In this case, purchasers of the preferred are given the privilege of buying 40% of the issued common at varying prices over a term of years.

In fifteen cases, the compensation of the organizers is in the form of common stock received with, or without, an underwriting charge. In six cases, compensation is solely in the form of options to buy

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common stock at a future date coupled in a few instances with an annual service charge based on capital, or income. In eleven cases, a fixed percentage of the capital or net assets, or a fixed proportion of net income is the reward of management either with, or without, the other forms of remuneration. Where a fixed percentage of net assets is paid to the managers, the usual amount is around  $\frac{1}{2}$  of 1% annually. When a proportion of net income is paid, the figure is more variable ranging from 4% of gross income to 6% of net income to (in two instances) 20% of net income but only in case 8% (Goldman Sachs Trading Corporation) or 10% (National Bond & Share Corporation) is available for the common stockholders.

From this analysis, it is clear that the compensation received by the organizers and managers is closely connected with the opportunity for profit offered to the investor who purchases bonds or preferred stocks of such companies either carrying warrants to buy common or convertible into the equity stock. This applies in still greater degree, of course, to the direct purchase of investment company common stock. Assuming that management ability of the larger investment companies over a period will prove to be approximately equal (which is probably not true), the next question is which one, or ones, offer the investor, from the point of view of capital structure, the most attractive opportunity for participation in the profits expected.

Compensation of management or organizers by a fixed percentage of common stock, or a periodical charge on assets or income is a direct and simple arrangement, the effects of which are easily seen. The option feature is more obscure. In principle, the option, or right to purchase stock at a future date at the

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issue (usually) or a higher price, is based on the fact (of common occurrence) that the stock of an investment company or bank with well known and highly regarded management is worth more than the cash issue price at the time of issue. This is due to the intangible value of superior management which the market in due course, proceeds to add to the price of the stock. In a recent case, the stock of such a company sold in the market, when, as and if, for twice its issue price before it was issued. In the right pocket, one dollar is made to do the work of two.

The effect of outstanding options in large amount is important as a source of asset dilution and price depression as the liquidating value and price of the stock increase and should be carefully investigated in each individual case. A simple example will illustrate this. Assume a company sells 100,000 shares of common at \$30.00 net and the managers receive warrants, good indefinitely to buy 50,000 shares at \$30.00. The stock in the next three months advances to \$45.00 and the managers exercise their rights purchasing 50,000 shares for \$1,500,000 at \$30.00 per share. There are only market reasons why these new shares are not worth substantially as much as the old ones and, subject to market conditions, should be valued at about the same price inasmuch as the company has presumably not greatly increased its assets. Assume however, that the options are exercised at a later date when the liquidating value of the stock has advanced to \$50.00 and the shares are selling at \$75.00. In this case, the liquidating share value is lowered to \$43.33 and the value of each share drops to \$65.00, a decline of over 13%. If the liquidating value has advanced to \$100, and the share price to \$150, the depressing effect of the exercise of the options is still

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more serious, the share value (on the same basis) being lowered to \$115, a 23 1/3% decline.

The American Founders Trust by June 1, 1926 according to its management contract with the International Securities Trust of America had earned options on 125,251 1/3 shares of common stock of the latter at an average price of a little over \$11 a share. At that time, the International Securities Trust had outstanding 48,393 shares with a book value of \$47.54 and a market price of \$74. Exercise of the options would have reduced the book value of International Securities Trust shares to about \$20 from \$47.54 and the market value to around \$30 from \$74. It was an impossible situation and the American Founders Trust wisely recognizing it, rescinded the fiscal agreement and in lieu thereof purchased 600,000 shares of B stock and 10,538½ shares of A stock of the managed trust at a favorable price—about \$2,600,000 in total.

These examples, one imaginary and one actual, illustrate the danger to investors of not familiarizing themselves with the option situation and its possible effect on the prices of shares of the investment companies in which they become interested. For the organizers of investment companies who own warrants for a large percentage of the shares of their companies, the situation, too, has a peril through a possible loss of valuable goodwill arising from a depreciation in share prices not suspected by that large class of buyers who take too much for granted. This peril may, however, be obviated by a gradual exercise of options owned rather than their retention as an investment. For these reasons, it is probably desirable that options should not extend in time over five years, or that the terms should be such that only a small percentage should remain outstanding at the end of

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that period, or, as is frequently the case, such rights should be at a steadily rising scale of prices.

It is altogether probable that, through the option device, the organizers of some investment companies have put entirely too high a price upon their ability to make profits, or have leaned heavily upon the credulity of an indiscriminating public. Where options are outstanding, it goes without saying, that the number and terms should be clearly stated in sales literature and they should be carried in the balance sheet as a part of the capitalization, or shown in a note on the same page.

An arrangement having some of the characteristics of the option is the division of the common stocks into A and B shares, one group, usually the B shares being owned by the management and having a deferred dividend status. This is well illustrated by the American Founders group of investment companies, the Founders company receiving blocks of B shares in its various managed companies. In such cases, the effect on the A shares of the B shares gradually increasing participation in profits should be calculated by the investor.

### Legitimate Underwriting Charges

The amount of the underwriting fee, or the expense of selling the investment companies' securities is an index of value both as to the attitude of the organizers toward the public and of the attitude of the public toward the organizers. Several of the larger companies have secured subscriptions ranging over \$10,000,000 without charging any such fee, or being put to any material selling expense. Bankers of other companies have received only nominal sums to cover expenses and salesmen's commissions. Others have nearly reached the limit, in the writer's opinion, of

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10% of the capital raised. An underwriting, or selling cost of not over 5% for large scale enterprises is reasonable. For less well-known and smaller undertakings, the legitimate expense of organization and selling may run somewhat higher.

Of more significance than the underwriting cost are the powers and policies of the management. Here, as indicated in the beginning, there are wide variations which can and should be ascertained by the careful investor. As to a selection, the average investor will doubtless be swayed by his judgment, his prejudices and the sales appeal. It may be noted here again that the most "restricted" trust cannot survive bad management and that trustworthy management can probably operate to better advantage unhampered by special restrictions. It seems probable that investment holding companies with broad powers and specialized activities will prove to be the most profitable and will require and attract a superior management personnel. The investor, however, should never forget that his chief guarantee of security and eventual profit lies in the integrity and ability of the management and the controlling interest of investment companies, organized as they are under general corporation laws and unsupervised by any special government department. Frank publicity as to investment policy, if not investments, income from interest and dividends, realized and unrealized profits, earnings on invested capital and on the common stock given in comparative form and on the liquidating value is indispensable to the investor and to the good name of investment companies as a class.

### Preferred Stocks and Bonds

A word should be said about the relative advantages of investment companies that issue preferred stocks

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and bonds and those capitalized with common stock only. Peculiar advantages have been claimed for the former. These are mainly illusory as the latter type normally enjoys a proportional credit line with its bank, or banks, to take advantage of special opportunities, and when a transaction is closed can retire the loan until again needed. In other words, its buying power is not restricted to its common share capitalization.

After the investor has satisfied himself as to the management and other characteristics of one or more investment companies, the problem appears of determining a fair price for the particular security which he is offered. If it is a bond and is protected by a 100% or more equity, and earnings more than double the interest required, he should expect to buy it on about the same basis as a high grade industrial, at present around 5%. If it is a preferred stock backed by assets 150%, or more of the total bonds and preferred stock and an earning power of twice, or more, the total interest and preferred dividends, he can expect to buy it also on the same basis as a good industrial preferred stock. Currently, owing perhaps to an over supply and lack of seasoning, good investment company preferred stocks are available on an attractive basis ranging upward from 6%.

### Relation of Market Price to Liquidating Value

The real difficulty is in determining wisely the fair price of an investment company common stock. The intangible factor of the public's estimate of the management causes wide variations of market price in relation to liquidating value and to earnings, if any. Where common stocks are being sold continuously as is the practice of some companies, it is obvious that

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the market value should not range very much over the true asset value. Incorporated Investors sells its stock in this manner at 5% above the liquidating value and the price hovers around that figure. Its liquidating share value and the price with it have steadily mounted, but there is no intangible element in the price. If the company suddenly ceased the sale of stock, the price could be expected to rise promptly to a higher figure, the difference representing the "value of management" factor. In cases where sale of stock is in blocks and the management popular, the price can and does double with little or no change in liquidating value.

A list of fifteen such stocks shows a range in price over liquidating value from minus  $1\frac{1}{2}\%$  to over 300%. Shares of an investment company capitalized with common stock only and earning 10% net on invested capital might be fairly priced at 40% to 50% in excess of share liquidating value. If the past record of the management indicates that it can average 20% or more on its funds, a price of 150% to 200% above the liquidating value might be reasonable. It seems probable that the best investment company stocks will eventually sell as high in proportion to earnings and asset value as the best bank stocks which they most resemble minus the double liability feature. To get a line on the market of a common stock preceded by bonds and/or preferred stock, a simple rule is to add 30% to 100%, or more, depending upon one's estimate of the management's worth, to the liquidating value of the investment company's total assets. Then deduct the paid in, or redemption value of the bonds and preferred stock, divide the result by the number of outstanding common shares and compare with the market price and earnings, if any, available per common share.

## Investment Trusts and How to Judge Them

Very few, probably no, American investment companies have a sufficiently long earning record to develop a stable price earnings ratio. In any event, the nature of the business is such that huge and quick profits may be made in any year, almost at any time, by the more aggressive companies of the holding company type, while others investing largely in bonds and preferred stocks and active in trading to advantage may also have unusually profitable years. This renders an appraisal of such common stocks difficult on an earning basis alone. Such a comparative appraisal is especially difficult at present and of little value owing to the frequent capital changes, new issues, exercise of options, inadequate information, different methods of presenting figures and even varying methods of calculating earnings practiced by different companies, or even by the same company.

The investment company is here to stay, to grow and to become an increasingly influential factor in the security markets not only of this country, but of the whole world. Vast profits are in store for some to the jubilation of their owners, while others, according to precedent, will fall by the wayside. It will repay the investor many fold, the writer predicts, to give them careful and continuous study, to select and buy the shares of those whose organizers have a background of investment success and a claim to his confidence and to pass by those floated for sales profits or for the sake of being in style. It is a time to look before leaping, but it is also a time to leap, for opportunities are thronging now in this field that will make history.



## CHAPTER VIII

### Opportunities in Seasonal Movements

**N**EARLY all industries show a tendency to earn more at certain seasons of the year than at others. This is especially true of lines that are affected by the weather or by business conditions around the holidays.

If a summer is hotter than usual, companies that deal in ice, soft drinks, ice cream, milk, refrigerators, soda fountain equipment, sporting equipment, and those that furnish out-of-doors amusement, are likely to enjoy earnings above the average; whereas a summer of abnormally low temperatures is likely to result in a year of disappointing earnings. Sugar growers and refiners are also likely to profit by an unusually heavy consumption of soft drinks.

Producers of furs and woolen goods usually benefit by an early and cold winter, and so do those who supply anthracite coal and heating apparatus. A long, open winter benefits the producers of automobiles and accessories, and tends to increase the consumption of gasoline; though the spring season is usually the most profitable for automobile manufacturers.

Department stores, cigar stores, and other retail dealers who cater to the holiday trade, usually do their biggest business in December.

Concerns that supply the building industry find winter their poorest season. In the steel industry, earnings are usually best in the spring and fall quarters. And so with other industries which will readily occur to the reader.

It seems quite natural to expect that seasonal in-

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fluences of this character would be responsible for quite a number of market movements in special groups and individual stocks; yet this method of selecting trading opportunities is by no means so reliable now as in former years. People are beginning to realize that a stock's worth is determined by the course of earnings over a period of years, and that it is not wise to draw hasty conclusions from the showing made in a single year, still less in an isolated season.

It has become customary of recent years for investors to compensate so far as possible for seasonal variations in earnings by estimating results for the current year on the assumption that the whole year will show the same percentage change in earnings as has been reported for that portion of the fiscal year which has already passed. If, however, indications point to a slowing down or speeding up of activities during the remainder of the year, the estimate would be reduced or augmented accordingly. If, for example, a company's earnings show a 10 per cent increase during the first half of the current fiscal year, as compared with the first six months of last year, it would be estimated that results for the full year will be 10 per cent better than last year, unless there are reasons for supposing that the second half year will show a greater or less percentage rate of increase.

Still bearing in mind that seasonal considerations are no longer so useful to the trader as they once were, it may be observed that seasonal movements, when they do occur, are of three kinds. First we have the movement that is incited by unusual weather. A few days of heat in early summer or late spring, that is abnormally high for the time of year, may stir traders to instigate an upward spurt in the hot weather stocks, and a late summer may bring about an opposite movement. Second, we may have movements

## Opportunities in Seasonal Movements

scheduled by the calendar. Someone will recall that this is the first day of summer, and begin buying the summer stocks, regardless of temperature. Or the approach of the holiday season may stir up buying in the mercantile stocks, regardless of whether general business conditions augur well or not for the Christmas trade. And third, we have seasonal movements based upon more or less definite knowledge of the current quarter's earnings. As a general rule the latter type of seasonal movement is the most pronounced in magnitude and is engineered by some pool with advance information. When the report is made public it is likely to precipitate a reaction caused by profit taking. For this reason, outsiders will find it prudent to wait for this reaction before basing commitments upon published reports of earnings; otherwise they are likely to be caught long at the top, or short at the bottom.

Seasonal movements of the first type are fitful, and one has to be a very clever and agile tape reader to profit by them. Movements of the third type present the best opportunities of the three for traders and spec-vestors who are skilled at chart reading. In this connection it is important to observe, however, that individual issues do not often move far against the main trend of the general market. Even the strongest pool finds it difficult to discount favorable earnings during a major decline in the combined averages, and poor earnings do not do so much damage to a stock when the rest of the market is strong as when the main trend is downward.

Seasonal movements of the second, or purely mechanical type, are analyzed for the past three years in Table I. This table goes quite extensively into the much discussed question as to whether certain months of the year are likely to produce upward or downward

## How to Secure Continuous Security Profits

movements in various industrial groups or in the market as a whole. When studying the results it is well to bear in mind that all three years witnessed a bull market in the general price level, and that this upward trend naturally exerted its influence upon all groups. For this reason we find that months of advancing prices considerably outnumbered those of declining prices in most groups. It should be observed, too, that both advances and declines in the various group indexes vary greatly in magnitude from one month to another and during the corresponding months of different years. The table shows the price unchanged during a month only when it neither advanced nor declined so much as a tenth of a point. For these reasons, and also on account of the limited number of years studied, traders should be cautious about basing their commitments too confidently upon the indications derived from Table I.

The Table presents a number of curious and unexpected results, for which we have space to mention only a few. It will be noted that there is a pronounced tendency for group movements to parallel those of the Combined Average. Only one of the groups, Textiles, fails to show any uniform monthly movement whatever for the three year period: yet this is generally classed as a seasonal industry. There are other groups, however, in which uniform monthly movements in the stocks bear little logical relation to seasonal variations in earnings. Marine stocks, for example, have declined uniformly in June and July of all three years, despite the fact that these are months favorable to shipping interests. In other instances, the movements seem more logical. One would expect construction stocks to advance during July and August, for example, since these are active months in the building trade.

# Opportunities in Seasonal Movements

TABLE I  
SEASONAL MOVEMENTS IN INDUSTRIAL GROUP INDEXES  
(M. of W. St. Common Stock Price Index)

Group	Year	Month											
		J	F	M	A	M	J	J	A	S	O	N	D
COMBINED AVERAGE .....	1926	A	D	D	A	A	A	A	A	A	D	A	A
	1927	A	A	D	A	A	D	A	A	A	D	A	A
	1928	A	D	A	A	A	D	A	A	A	A	A	D
	3-Yrs.	A	—	—	A	A	—	A	A	A	—	A	—
Amusement .....	1926	A	D	A	A	A	D	A	D	A	D	A	A
	1927	A	A	D	D	A	D	A	D	A	D	A	D
	1928	D	A	A	A	A	D	A	A	A	A	A	D
	3-Yrs.	—	—	—	—	A	D	A	—	A	—	A	—
Automobile Accessories .....	1926	A	D	D	D	D	A	A	A	A	D	D	A
	1927	D	A	D	A	A	A	A	A	D	D	A	D
	1928	D	A	A	A	A	D	A	A	A	A	A	A
	3-Yrs.	—	—	—	—	—	—	A	A	—	—	—	—
Automobiles .....	1926	D	D	D	D	D	A	A	A	D	D	D	A
	1927	D	A	D	D	A	D	A	A	D	D	A	A
	1928	D	A	A	A	A	D	D	A	A	D	A	A
	3-Yrs.	D	—	—	—	—	—	—	A	—	D	—	A
Business Machines .....	1926	D	D	D	A	A	A	A	A	A	D	A	A
	1927	A	A	A	A	A	D	A	U	D	D	A	A
	1928	A	D	A	A	A	D	A	A	D	A	A	A
	3-Yrs.	—	—	—	A	A	—	A	A	—	—	A	A
Cans .....	1926	D	A	D	A	A	A	A	D	D	D	A	D
	1927	D	A	D	A	A	A	A	A	D	D	A	A
	1928	A	A	A	A	A	D	A	A	D	D	A	A
	3-Yrs.	—	A	—	A	A	—	A	—	D	D	A	—
Construction & Bldg. Material..	1926	D	D	D	D	A	A	A	A	D	D	A	A
	1927	D	A	D	A	A	D	A	A	D	D	A	D
	1928	A	D	A	A	A	D	A	A	A	A	A	A
	3-Yrs.	—	—	—	—	A	—	A	A	—	—	A	—
Copper .....	1926	D	D	D	A	D	A	A	D	A	D	A	A
	1927	D	A	D	A	D	D	A	A	A	D	A	A
	1928	D	D	A	A	A	D	A	A	A	A	A	A
	3-Yrs.	D	—	—	A	—	—	A	—	A	—	A	A
Department Stores .....	1926	D	D	D	A	D	A	D	A	D	D	A	D
	1927	U	A	D	A	D	D	A	A	A	D	A	D
	1928	D	D	A	A	A	D	A	A	D	A	A	D
	3-Yrs.	D	—	—	A	—	—	—	A	—	—	A	D

# How to Secure Continuous Security Profits

TABLE I—*Continued*  
SEASONAL MOVEMENTS IN INDUSTRIAL GROUP INDEXES  
(M. of W. St. Common Stock Price Index)

Group	Year	Month											
		J	F	M	A	M	J	J	A	S	O	N	D
Drugs & Toilet Articles.....	1926	A	D	D	A	A	A	A	A	D	D	A	D
	1927	D	A	D	A	A	D	A	D	A	A	A	D
	1928	A	A	A	A	A	D	A	A	A	A	A	D
	3-Yrs.	—	—	—	A	A	—	A	—	—	—	A	D
Electric Apparatus .....	1926	A	D	D	A	D	A	A	A	D	D	A	D
	1927	D	A	D	A	A	A	A	A	D	D	A	A
	1928	D	D	A	A	A	D	D	A	A	A	A	A
	3-Yrs.	—	—	—	A	—	—	—	A	—	—	A	—
Fertilizers .....	1926	A	D	D	D	A	D	D	A	D	D	A	D
	1927	D	A	D	A	A	A	A	A	A	D	A	A
	1928	D	D	A	A	A	D	A	A	A	D	A	D
	3-Yrs.	—	—	—	—	A	—	—	A	—	D	A	—
Furniture & Floor Covering....	1926	A	D	D	D	A	A	A	D	A	D	D	A
	1927	D	A	D	A	A	D	A	A	D	D	A	A
	1928	A	D	A	A	D	D	D	A	A	A	A	A
	3-Yrs.	—	—	—	—	—	—	—	—	—	—	—	A
Mail Order ...	1926	D	D	D	A	A	A	A	D	D	U	U	A
	1927	D	A	D	D	A	D	A	A	A	D	A	A
	1928	A	A	A	D	A	D	A	A	A	A	A	D
	3-Yrs.	—	—	—	—	A	—	A	—	—	—	A	—
Marine .....	1926	A	D	A	D	A	D	D	D	A	A	D	A
	1927	A	D	D	A	A	D	D	D	D	D	A	D
	1928	D	D	A	A	A	D	D	A	A	D	A	D
	3-Yrs.	—	D	—	—	A	D	D	—	—	—	—	—
Petroleum & Natural Gas.....	1926	A	D	D	A	A	A	D	A	D	A	D	A
	1927	A	A	D	D	A	A	D	D	A	D	A	A
	1928	A	D	A	A	D	D	A	A	A	A	A	D
	3-Yrs.	A	—	—	—	—	—	—	—	—	—	—	—
Public Utilities .....	1926	A	D	D	A	A	A	A	D	D	D	A	A
	1927	D	A	A	A	A	D	A	A	A	D	A	A
	1928	A	D	A	A	A	D	D	A	A	A	A	A
	3-Yrs.	—	—	—	A	A	—	—	—	—	—	A	A
Railroad Equipment .....	1926	D	D	D	A	A	A	A	A	A	D	A	D
	1927	D	A	D	D	A	D	A	A	D	D	A	D
	1928	D	D	A	D	D	D	D	A	A	D	A	A
	3-Yrs.	D	—	—	—	—	—	—	A	—	D	A	—

# Opportunities in Seasonal Movements

TABLE I—Continued  
SEASONAL MOVEMENTS IN INDUSTRIAL GROUP INDEXES  
(M. of W. St. Common Stock Price Index)

Group	Year	Month											
		J	F	M	A	M	J	J	A	S	O	N	D
Railroads .....	1926	D	D	D	A	A	A	A	A	A	D	A	A
	1927	A	A	D	A	A	D	A	D	A	D	A	D
	1928	D	D	A	A	D	D	D	A	A	D	A	D
	3-Yrs.	—	—	—	A	—	—	—	—	A	D	A	—
Shoe & Leather.....	1926	D	D	A	D	A	A	D	D	U	D	A	D
	1927	A	A	A	D	A	D	A	A	A	A	A	D
	1928	A	D	A	A	D	D	A	A	D	D	D	A
	3-Yrs.	—	—	A	—	—	—	—	—	—	—	—	—
Steel & Iron.....	1926	D	D	D	D	A	A	D	D	A	D	A	A
	1927	A	A	A	D	A	D	A	A	D	D	A	A
	1928	A	D	A	A	A	D	A	A	A	A	A	D
	3-Yrs.	—	—	—	—	A	—	—	—	—	—	A	—
Sugar .....	1926	A	D	D	D	D	D	A	D	A	D	A	D
	1927	D	D	D	A	A	D	A	A	D	D	A	A
	1928	D	D	A	A	A	D	D	D	D	D	A	D
	3-Yrs.	—	D	—	—	—	D	—	—	—	D	A	—
Sulphur .....	1926	A	D	A	A	A	A	D	D	A	D	A	A
	1927	A	A	A	A	A	A	A	A	A	A	A	A
	1928	D	D	A	D	D	D	A	D	D	A	A	A
	3-Yrs.	—	—	A	—	—	—	—	—	—	—	A	A
Telephone & Telegraph.....	1926	A	D	D	A	A	D	D	A	D	U	A	A
	1927	A	A	A	D	A	D	A	A	A	D	A	D
	1928	D	A	A	A	A	D	D	A	D	A	A	A
	3-Yrs.	—	—	—	—	A	D	—	A	—	—	A	—
Textiles .....	1926	A	D	D	D	D	A	D	A	A	A	A	A
	1927	D	D	D	A	A	D	A	D	D	D	D	D
	1928	A	A	A	D	D	D	A	D	A	A	A	D
	3-Yrs.	—	—	—	—	—	—	—	—	—	—	—	—
Tire & Rubber.....	1926	A	D	D	D	D	A	D	A	D	D	D	A
	1927	A	A	A	A	D	D	A	A	A	D	A	A
	1928	U	D	A	D	D	D	A	A	A	U	A	A
	3-Yrs.	A	—	—	—	D	—	—	A	—	D	—	A
Tobacco .....	1926	A	D	D	U	A	A	A	A	A	D	A	A
	1927	D	A	D	D	A	A	A	A	A	D	A	D
	1928	D	D	A	D	A	D	A	A	D	A	A	D
	3-Yrs.	—	—	—	D	A	—	A	A	—	—	A	—

Key: A—Advanced. D—Declined. U—Unchanged.  
Dashes indicate a mixed monthly trend for the three years.



## CHAPTER IX

### Selecting Securities on Production and Consumption Cycles

**T**HERE are few industries that enjoy uniform prosperity year after year. Many pass through a more or less well defined cycle of ups and downs in which the prices of leading stocks in the industry participate. Prior to 1922, the great majority of these advances and recessions coincided with major changes in general business conditions; but, of recent years, we have experienced no country wide business depression of old-time severity, and the prosperity cycles of different industries have pursued more or less independent courses in response to purely internal economic influences. Traders and speculators will find it well worth while to purchase the stocks of favorably situated companies during the rising phase of a cycle at a time when the general market trend is upward; but long term investors should avoid stocks among the cyclical industries so far as possible, since it requires constant vigilance to select the best time to get in and close out.

The method of judging when to buy stocks of companies whose profits vary from year to year according to a more or less well defined cycle of ups and downs is based upon a study of the so-called "Industrial Barometers." The supposition is that stocks of well managed companies will continue to advance in market price so long as the industry's outlook remains favorable; but that they should be disposed of promptly

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when the outlook becomes obscure or unfavorable. In what follows we shall draw rather freely from material presented in "The New Technique of Uncovering Security Bargains," published by *The Magazine of Wall Street*.

### Group Barometers

The function of a stock market barometer is to give advance notice of when turning points in the main trend of individual issues, or groups of stocks, are likely to take place. So long as the barometer—plotted as a graph, or so-called "Forecasting Curve"—tells one when to buy and when to sell, it is not essential to know the magnitude of coming price movements.

Stocks are usually prompt in responding to any developments which point to changes in earnings. The formula for earnings is volume of sales, times unit selling price, less expenses. Any reduction in expenses is a bull argument; but reductions are usually effected so gradually that they need not be considered by the trader or spec-vestor. Unit prices and volume of sales, shipments, or output, however, frequently fluctuate over a comparatively wide range within periods of a few months, and are thus valuable for forecasting purposes.

When unit prices are steady, or changing slowly, volume of business is the factor to watch. When unit prices change rapidly, these alone should be used for the barometer. This is due to the practical observation that rising prices are usually accompanied by an increase in the physical volume of business, whereas falling prices are generally the outcome of a declining volume of business. In industries where the unit cost of raw material fluctuates widely, selling prices—though more sluggish—usually follow raw material

## Selecting Securities on Production and Consumption

costs in such a way that the margin of profit increases on rising prices and diminishes on falling prices. Frequently, representative data on selling prices are lacking in such instances, so that unit prices of raw material are the figures to use in constructing the barometer.

When volume of business is used as a barometer, the curve should be plotted to show the amounts by which business each month exceeded or fell behind the corresponding month last year. This we call the "Difference Curve." When unit prices are used as a barometer, the difference curve should be employed in industries that are seasonal in character: otherwise, actual prices should be plotted, but to logarithmic ordinates.

In some industries, where fluctuations in raw material prices are foreshadowed by changes in the amount of accumulated stocks, a "Stocks Difference Curve" may be utilized as a secondary barometer for forecasting turning points in the Price, or in the Price Difference, barometer. The stocks difference curve, however, should be inverted to show increases below the zero line, and decreases above; since increasing stocks point to falling prices, and decreasing stocks to rising prices. Here we have a barometer of a barometer, which enables us to forecast turning points in the common stocks of an industry many months in advance. We are now in a position to utilize these general principles in the construction of forecasting barometric curves for a number of the major industries.

### Automobiles

Owing to the highly competitive conditions which have obtained in the automobile industry of recent years, stocks in this group have followed such divergent price paths that an industrial barometer

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would be meaningless. The market trend of individual issues which are likely to experience the most pronounced upward movement can be inferred with considerable dependability, however, from published information about price changes, earnings, sales, shipments and production.

### Automobile Accessories

Turning points in the monthly Automobile Production Difference Curve usually antecede, by a few months, most of the important turning points in automobile accessory stocks as a group.

### Copper

The barometer here is the actual wholesale price of copper, platted to logarithmic ordinates. Turning points in this price barometer usually anticipate by several months the corresponding turning points in leading copper stocks. Curves showing monthly world production of blister copper, and North and South American stocks of blister plus refined, are useful secondary barometers of the primary price barometer. As a general rule, decreases in stocks and in production favor price advances in the metal; and *vice versa*.

### Merchandising Stocks

Profits of merchandising companies, and hence the broader movements of their securities, depend largely upon the general prosperity of districts in which they are located. About the best barometer for department, haberdashery, and grocery stores is therefore the difference curve of debits to individual account,

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reported by the Federal Reserve Board for the section in which the store is located. Drug, tobacco, mail order, and variety chains report monthly sales and these, checked up with periodic earnings reports, afford valuable clues to the future trend of individual stocks in those fields.

### Petroleum

Here the primary barometer is constructed from the number of wells brought in each month as compared with the number brought in during the corresponding month of the previous year. This is because drilling operations respond quickly to changes in the price of crude. Every important angle in the "Wells-brought-in Difference Curve" is followed, within a few months, by corresponding changes in the strength of petroleum stocks relative to the general market as a whole. An inverted "Stocks Difference Curve" is of assistance in forecasting the primary barometric curve; but indications from this secondary barometer are at times uncertain.

### Public Utilities

So far as the writer has discovered, there are no satisfactory barometers for any of the sub-groups of this broad industry. Individual stocks can be forecasted fairly well from their "Earnings Difference Curve"; since most of the companies in this field report monthly.

### Railroads

Railroad stocks are generally stronger than the general market so long as car loadings run ahead of the corresponding period of the previous year, and turn

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weaker than the general market when loadings run behind last year.

### Shoes and Leather

The same set of barometers serves equally well for both Shoe and Tanning stocks. Turning points in these stocks, as a group occur with great regularity within three or four months after corresponding turning points in the "Hide Price Difference Curve." An inverted "Hide Stocks Difference Curve" serves, in turn, as a secondary barometer for the Hide Price Difference Curve; so that it is frequently possible to forecast the major movements in the common stocks of this industry a year or more in advance.

### Steel

As this industry is seasonal, and prices of finished products change slowly, the barometer that would normally apply here would be the "Steel Ingot Production Difference Curve." Turning points in this curve, however, coincide closely in time with turning points in comparative strength of leading stocks in the steel group—instead of occurring several months in advance. For this reason it is not an ideal barometer. Fortunately, in this instance, we have a good secondary barometer in the "New Orders for Steel Castings Curve," whose turning points occur about two months in advance of the Steel Ingot Production graph.

### Sugar

Sugar stocks usually remain stronger than the general market so long as the excess of raw sugar prices over the year before continues to increase; and are weaker than the rest of the market so long as this

## Selecting Securities on Production and Consumption

spread in comparative prices grows narrower, or so long as raw sugar prices rule below those of the year before.

### Tire and Rubber

The monthly average price of crude rubber, platted to logarithmic ordinates, generally anticipates by a few months all important changes in comparative strength of stocks in this group. If crude prices remain fairly steady, comparative changes in the volume of production, or in wholesale prices of the finished product, take on barometric significance.

### Tobacco

The Cigar and Cigarette stocks should be treated as separate groups. About the best available barometers for the two sub-groups are the respective difference curves of Cigar and Cigarette consumption as indicated by monthly withdrawals from bonded warehouses. As a general rule, common stocks in these groups will rise or fall for a few months, beginning shortly after publication of Government figures showing any marked comparative increase or decrease in consumption.



## CHAPTER X

### How to Profit by Stock Dividends and Rights Cash Dividends

**B**UYING for the dividend is one of the oldest of plans for scalping small profits out of the stock market. Up to a few years ago, however, stock dividends and rights were relatively rare occurrences, so that traders had to content themselves with trying to guess when a stock would proceed to make up its cash dividend.

Bonds are quoted "and interest," and so offer no opportunities to trade for the interest. If a six per cent. bond, interest payable January 1 and July 1, is quoted on April 1 at 100, for example, the true cost (disregarding commissions) would be \$1,015—\$1,000 for the bond, plus \$15 for accrued interest.

Both common and preferred stocks, however, are quoted "flat"—i.e., without accumulated dividends. If dividends are payable quarterly, which is by far the commonest practice, a person who buys the stock the day before it sells "ex-dividend" pays the same price and is entitled to the full dividend just the same as a person who bought three months earlier. But, when a stock sells "Ex," the amount of the cash dividend is deducted immediately from the price of the stock. Otherwise, anyone could buy the stock the day before it sells "Ex" and receive the full quarter's dividend next day. In other words, he would receive a sure three-months' interest on a day's investment.

Obviously, in order to earn three months' interest, money ought to remain invested for three months.

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Theoretically, then, a six per cent. preferred stock which is priced at 100 the day it sells "Ex" should rise uniformly in price at the rate of half a point per share per month until it reaches 101½ after three months, when the price will again drop overnight to 100 on the day it sells "Ex" the regular quarterly dividend. In other words, the cash dividend would be "made up" gradually and uniformly. Other influences aside, common stocks might also be expected to make up their dividends in the same manner.

In practice, however, neither common nor preferred stocks discount their cash dividends uniformly. It is hard to know just when a preferred stock is recovering its dividend; for the spread between bid and ask prices, and hence the price interval between consecutive sales, will frequently be as large or larger than the quarterly cash dividend—especially in inactive stocks. Since the dividend on a preferred stock is fixed, moreover, the issue never does any more in the long run than just make up its dividend—other conditions, such as money rates and seasoning influences, being equal.

Common stocks, on the other hand, have a habit of making up more than the cash dividend—not gradually, over the three-months' interval, but within the space of a very few days. Usually this takes place sometime during the week before the stock sells "Ex," or during the week following, though there are many exceptions, especially during reactionary periods in the general market; so that the rule by no means offers a short cut to wealth. If the rise takes place before the stock sells "Ex," it is said to be "discounting" the dividend: if afterward, it is said to be "making up," or "recovering" the dividend.

It is difficult to decide, in a given instance, whether the rise that takes place in a common stock around

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the time it sells "Ex" is caused by the dividend, or by other circumstances—especially the knowledge of quarterly earnings. Chart students have observed that common stock prices have a tendency to move in investment cycles of three months or multiples thereof. It is natural to attribute this to the fact that earnings are usually compiled quarterly, even though sometimes reported less frequently. Since market movements frequently arise from manipulation—or even plain buying and selling—by insiders who know the latest earnings before they are published, it is quite natural that common stock prices should swing in quarterly cycles, regardless of dividends. In fact the quarterly price cycle is probably as common among non-dividend payers as among stocks that pay regular cash dividends.

### Stock Dividends and Rights

There is a belief among speculators that common stocks also make up their stock dividends: in other words, that the price will eventually come back to where it was before the stock sold "Ex" the stock dividend. In seeking an explanation for this, we shall find that the same considerations apply to rights; for, as pointed out in Chapter IV, rights are merely a form of stock dividend.

The stocks that pay stock dividends and offer rights to stockholders are usually of growing companies whose earnings will eventually rise to the point where the new stock will be worth as much per share as the old stock before it sold "Ex" the stock dividend. Moreover, since directors seldom declare a stock dividend unless the outlook looks favorable, and since dividends on the new stock are at the same rate as on the old (otherwise it could not be called a pure stock dividend), it frequently happens that the new stock will rise to the price of the old within a period of a

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few months to a year, depending upon the size of the stock dividend. This recovery is aided by the fact that stock dividends are usually declared during periods of general business prosperity while a bull market is in swing among many other stocks.

But while the *spec-vestor* can buy a stock profitably as soon as it sells "Ex" the stock dividend, or ex-rights; the *trader* should bear in mind that part of the rise will be discounted temporarily before the stock sells "Ex," beginning around the time that rumors of the coming mellon begin to circulate. For a period after the stock sells "Ex," however, the price is likely to sag slowly, or at best stand still, while the added floating supply is being assimilated. The length of this assimilation period depends much upon the magnitude of the stock dividend, and upon conditions in the general market. A hundred per cent. stock dividend in a dragging market will postpone the recovery longer than, say, a 20% stock dividend in a bull market. It is well to know, too, that there will usually be a rather prompt false start on the recovery, instigated by short covering, followed by a rather prolonged sagging period which usually ends with prices somewhat above the old low point since the dividend came off.

In the writer's experience, the sharp marking-up stage of the real recovery does not usually set in until after as many weeks as there are two-points in the price drop due to the dividend. For example: a stock closes at 100 the day before it sells "Ex" a 20% stock dividend. Next day the stock will open down 20 points. Dividing this by 2, we have 10 weeks as the probable interval before the main advance will be resumed with vigor. Like all rules for trading in the stock market, however, this one has many exceptions. It is merely a rough guide.

## CHAPTER XI

### How to Take Advantage of Basic Developments in Industry

**T**HE only essential difference between a trader and the modern scientific investor is in the length of time that his securities are held. Both endeavor to select securities that will appreciate in value, and to dispose of them when the possibility of further profit is exhausted. The investor who buys for income only, to hold "till death do us part," is becoming old fashioned. The security buyer of today is more keenly alive to changing conditions and his holdings are naturally subject to frequent examination and personal audit. Much more thought is given to income derived from price appreciation.

#### News

Now, buying for profit calls for greater vigilance than buying for income, even when the intention is to hold for a period of years. We are living in an age which is noted not only for its speed, but especially for the rate at which this speed is being accelerated. Conditions which determine values, and hence the market prices of securities, are always changing, and at a pace which quickens with the passing of each new decade. It is no longer sufficient for an investor to ascertain once for all that the investment he selects is safe as to principal and income. He must keep posted on developments, must

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read and digest all the news that may have any bearing upon specific industries and individual companies, in order to be alert for new opportunities and to recognize the proper time to dispose of securities whose prospects have become less attractive than when he bought them. Of course it goes without saying that those who aim to profit by the shorter swings must always sleep with both eyes and both ears open for any news that may influence the market.

When Wall Street uses the term, "News," it means the first announcement of some development, accomplished or pending, which is likely to have an influence upon the market prices of securities. With the exception of accidents and catastrophes, however, it should be remembered that this so-called "News" has usually been known to one or more groups of insiders before it is announced. There are also many new developments which are known to people who have no interest in the stock market, even before these reach the ears of insiders who are interested in the stock market. Court and commission decisions, inventions and discoveries, belong in this category. It may take a long time for important news to reach all the buyers and sellers who are influenced to act upon it, and the market's response to new developments will consequently depend upon who has the information, and when.

If the new development is of considerable importance marketwise, insiders usually act upon it before it is announced publicly; so that release of the news is frequently soon followed by a reaction. If the new development is of such character, however, as to exert a profound influence upon corporate earnings the reaction may be followed by a prolonged price movement interrupted only by the usual technical reactions. The basic developments covered in the

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present chapter are of this type, and so concern the investor and spec-vestor who buy for a comparatively long pull.

### Basic Developments

Developments of importance to the long pull and semi-long pull investor are those which govern the general business outlook (to be taken up in Chapter XII), those which alter the outlook for specific industries, and those which influence the earnings of individual stocks.

Among developments which may have an important bearing upon the price movements of industrial groups of stocks we find:

1. Mergers and the formation of trade associations to eliminate competition and trade abuses. Examples are recent organization of the British and American Tin Corporation to stabilize the production and marketing of tin; last year's (1928) merger of the International Nickel Co. with the Mond Nickel Co., thereby effecting control of 90% of the world's supply of nickel; and formation of the Copper Exports Association in 1927. The market response to news of this character is usually delayed for a sufficient period to allow investors ample time in which to accumulate their line of stock before the advance has gained much headway; but once the move has started it may easily cause the stocks which are affected by the development to at least double in price within a few years.

2. Court decisions and rulings of trade commissions. Examples of this are recent decisions by the Supreme Court directing that valuations upon which the rates charged by public utilities and the railroads are based shall take into consideration the present cost to reproduce a company's plant.

## How to Secure Continuous Security Profits

3. Any circumstance that leads to a rise in price of the chief commodity of an industry. Ordinarily this will be evidenced by curtailment of production, growth in demand, or a decline in accumulated stocks, or some combination of these favorable developments. When consumption exceeds supply, accumulated stocks are reduced. This is an almost infallible indication of a pending rise in price. There are quite a few industries for which we now receive, through Government bureaus or trade associations and magazines, quite reliable periodic reports regarding the size of accumulated stocks. Among the more important of these are copper, petroleum, rubber, leather, zinc, and used cars.

4. Direct competition within an industry, or indirect competition through growth in the use of substitutes. Inroads made by automobiles into the passenger and short haul freight traffic of our railroads, and the growing use of leather substitutes are instances of the latter.

5. The rise of new industries, in which investments have to be chosen with unusual discrimination; but which hold rich rewards for the far seeing. Among recent examples of these are radio, aviation and the "talkies", which will be considered further in Chapter XII.

6. Developments which affect more than one industry. Chief among these are occurrences which spread their effects over many industries in a certain section of the country, such as failure of, or low prices for, a region's principal crop, or collapse of a real estate boom; and developments which affect the purchasing power of customers or the cost of raw material used by a number of different industries. An excellent illustration of the latter was pointed out in an editorial which appeared in THE MAGAZINE OF

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WALL STREET, for July 27, 1929, from which we quote as follows:

"The related character and community of interests of certain stock groups was graphically illustrated when the price of wheat reached a new post war level some weeks ago. The falling price level in the great staple of the west was contemporaneous with marked declines in stocks representing at least six widely different industries whose prospects would be subject to adverse reactions from a small return on the harvests in the wheat belt.

"Agricultural implement stocks were the first to decline on the contention that lessened purchasing power among the farmers meant decreased sale in farm equipment. For the same reason weakness was manifest in fertilizer issues. Numerous motor car stocks declined on the same assumption of prospective foreshortened markets, as did the mail order stocks. Baking stocks, on the other hand, sold off on the probability of inventory losses. Heavy stocks of flour on hand would naturally be subject to drastic revision in value with the decline of the price of wheat and the consequent lowering in the value of flour.

"The reverse of this whole picture was as dramatically demonstrated within the short space of two days. On the proposal to utilize Federal funds, under the new farm relief legislation, to stabilize the price of wheat, the price of the staple staged a sensational recovery, establishing itself over the dollar level once more and following through for one of the most spectacular wheat movements since the War. Immediately the same industrial stock groups associated with the decline almost without exception began a concurrent up-trend.

"Thus we have a complete example of the integra-

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tion of certain portions of the market and of the close relationship, insofar as sympathetic price movements are concerned, between great stock groups. Perhaps more than anything else this emphasizes to the investor the need for keeping posted not only on all phases of the affairs of the companies in which he is interested, but in the industry and in the general business, industrial and economic trend."

Among developments which may have an important bearing upon the price movements of individual stocks we find:

1. Developments which are favorable to the industry in which the issuing company is engaged.
2. Changes in management.
3. Change in banking affiliations.
4. New customers.
5. New products.
6. New processes and inventions.
7. Reduced costs.
8. Court and commission decisions.
9. Mergers and acquisitions.
10. Rights, stock dividends, and changes in cash dividend rate.
11. Changes in the rate at which earnings are increasing or decreasing.
12. Prosperity of customers.
13. Prosperity of territory served.

An item in this morning's (Aug. 8, 1929) financial news will serve to illustrate the latter. (Development number 13.) "Inquiry of a director of the Bangor & Aroostook Railroad Co. as to the outlook for the Aroostook potato crop for the coming shipping season develops the following:

"While acreage planted in the county as a whole was slightly less than last year, the crop will be some-

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what larger and the potatoes will be of the best quality ever known. . . . In addition, owing to the acreage planted throughout the United States as a whole being much smaller than heretofore, and because of partial crop failures in other sections, prices will be remunerative. The average price received by farmers during the season which ended June 30 was \$1 per barrel or less, whereas contracts for new potatoes, shipment of which will begin this month, have been made at \$2.50 and \$2.75 per barrel.

"This means that Bangor & Aroostook Railroad will not only have during the next twelve months large shipments of potatoes to move, but that increased buying power of the farmers will result late this year or early next year in much enlarged freight traffic."

Here we have an item of news which should eventually lead to a considerable rise in Bangor Stock. It pays \$3.50; earned \$8.41 in 1927 and \$6.94 in 1928. It closed yesterday at  $83\frac{5}{8}$ , about ten times the 1927 earnings, and yielding 4.2%. The high this year to date was  $88\frac{1}{4}$ , which was also last year's high. The Company could pay \$4.00.



## CHAPTER XII

### Picking the Giants of the Future

**T**HERE are two distinct methods of profiting by opportunities in what are destined to be the giants of the future. Among these opportunities there are also two distinct types, promotions and seasoned companies. Either type presents opportunities, at times, to both traders and investors.

Trading opportunities in seasoned stocks that are destined to become giants of the future are to be recognized by the same well known methods that are employed with any other stock. This calls for skilled reading of the technical position, experienced interpretation of rumor and news, and searching analysis of financial statements and conditions within the industry. Trading opportunities in new and unseasoned stocks are obviously available only among issues that are listed upon some of the larger exchanges; because, as a general rule, the spread between bid and ask prices of unlisted stocks is too wide to permit the trader to get in and out quickly at a profit, and information on unlisted stocks is usually rather meagre.

### Imaginative Buying

Every now and then splendid opportunities to take quick trading profits are afforded during periods when the public mind becomes fired with a belief in the fabulous profits that are to be made in some new industry. In order to take advantage of these great

## How to Secure Continuous Security Profits

waves of "Imaginative buying," however, it is necessary for the trader to throw aside all of the commonly accepted standards of judging the market and quickly place himself in tune with the public's psychological mood of the moment. If he tarries to subject the situation to logical analysis founded upon known facts, the buying wave will have subsided.

As pointed out in an able article in *THE MAGAZINE OF WALL STREET* for November 3, 1928: "In this new era of rapid industrial progress, science, invention and research have been injected into speculative calculations. One by one, the motor truck, the Diesel engine, artificial silk, soft drinks, radio, electrical refrigeration, aviation and the "Talkies" have stirred up popular enthusiasm. Each of the industries represented by these names will be recognized as having had a prominent part, at one time or another, in the speculative bull movements of the period from 1921 to date.

"The phenomenal expansion of the chain store and automobile companies, oftentimes from one man affairs with an initial capital investment well down in five figures, has not failed to make a deep impression upon the popular mind. Taking full advantage of research, the motor industry in a little over thirty years rose to front rank among American enterprises. The example of the motor car has thus tended to inflame the speculative imagination and make it susceptible to the belief that other infant industries might easily duplicate its performance.

"For example, the spontaneous craze for radio stocks, four years ago, developed such proportions and vigor that the mere listing of a new issue was sufficient to induce an unrestrained rush of public buying. Prices moved absolutely without relation to values or earning power. Frequently neither of these

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was known or ascertainable. Out of that fad there emerged a few of the original stocks. But the majority of investors today probably cannot even recall the names of many companies which flashed across the market horizon in 1924.

"Nevertheless, the speculative urge will not down. Despite the lessons of the past, the rush to discount the possibilities in new industries is irresistible. There are no fixed or established standards to limit the play of imagination. Such is the regularity of these flare-ups, that each bull movement of late years has had its distinguishing outburst.

"The investor must take account of such waves of imaginative buying, both as a matter of self-protection when over-enthusiasm is rife, and also for practical reasons so that, insofar as possible, he may outguess the multitude and profit accordingly. At the same time, he will also read, from the experiences of the past, a lesson in the ephemeral nature of many such speculative eruptions and govern his own stock market transactions accordingly."

### New Companies

Imaginative buying is a disease that is especially prone to attack new industries and new companies; for speculation thrives upon mystery. Older companies, however, are sometimes subject to imaginative buying when it becomes known that they have discovered a new process, perfected a new invention, or are putting out a new line of products. Conspicuous recent examples of this are A. M. Byers, with its new Ashton process for puddling iron mechanically; American Linseed, which was converted into a food manufacturing company; and Union Bag and Paper in which a series of vigorous upward movements and

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precipitate declines were inspired by rumors and denials of a new process.

Trading opportunities in new companies are probably, on the whole, easier to recognize than long pull investment opportunities; for the trader sometimes has the aid of crowd psychology from which to take his cue. When it comes to picking the giants of the future out of the huge number of new companies which are organized each year, an investor is greatly handicapped by the absence of established earning power, and so has to fall back upon indirect considerations such as banking sponsorship, management, capitalization, nature of product, strength of patents, location, probable character and intensity of competition, and any other pertinent information that may be accessible.

Management and banking sponsorship are frequently the deciding factors in selecting both trading and long pull investment opportunities in new companies. Traders will remember the remarkable market performance, for example, of the various Ford foreign subsidiaries, several of which more than doubled in market price within a few weeks from date of issue. So great, indeed, was the public demand for the limited supply of stock available in this country that brokers could not fill their advance subscriptions. The sudden boom was followed by an inevitable reaction.

When it comes to selecting long range opportunities among new companies, the investor will find it extremely difficult to recognize those that are destined to become the giants of the future. Of the host of new companies that are organized during the earlier years of a new industry only a very few of the most strongly situated will survive. As a rule, these will be the ones that begin business under the strongest banking spon-

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sorship and with the strongest basic patents. In a number of instances, however, management will be the sole consideration, and this is a factor which is hard to evaluate at the outset.

There are several distinctly different types of new companies, and the method of judging their long pull possibilities varies considerably with each type.

FIRST we have the most difficult of all new companies to rate for investment possibilities, the ones whose management is only locally known, or whose directors may have no ascertainable records of successful business achievement. Such companies are commonly known as "New Promotions," and are often controlled by the inventor of some new process or device, and financed by personal loans or door-to-door subscription. Their beginnings are often small, and so it is likely to be years before the stock is listed on any recognized exchange, if it ever is. It is among new promotions that we find the widest extremes in long range investment merit. Some of the most successful concerns in the world had their small beginnings as one-man companies, and grew rapidly into huge national and international organizations, by sheer force of good management and persistent reinvestment of profits in expansion of the business. Concerns such as the Ford Motor Co., National Cash Register, and the F. W. Woolworth Co. have long since become household by-words as fabulously successful promotions. Unfortunately, a few of these great closed corporations are habitually cited by unscrupulous promoters as a lure to induce inexperienced investors to put their frugal savings into the watered stock of dishonest or visionary schemes which never will pay profits to anyone but the organizers.

The only safe way for an investor to escape loss in new companies promoted by individuals of un-

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proven business ability is to avoid such stock altogether, especially when it is offered to the general public. In order to circumvent this obstacle, dishonest promoters sometimes make unauthorized use of one or more prominent names in their literature, and may even gain the consent of reputable people to serve on the directorate, by misrepresenting the purposes for which the company is organized or the uses to which funds are to be applied. If still tempted to invest in promotions of this character it would be prudent, before reaching a final decision, to ask your bank if it will make you a loan of 50% of the purchase price, on security of the new stock. If not, don't buy it. Next communicate with some large unlisted security firm and ask for a quotation on the stock you are thinking of buying. You will doubtless be shocked to learn that you could resell the stock for only 60% to 80% of the price asked by the salesman.

SECOND are new companies organized by well known bankers and business executives and underwritten by responsible banking or brokerage houses. The possibility of immediate trading profits in stocks of this character depends largely upon conditions in the general market and the public's estimate of the new venture at the time such stock is floated. If the new company is launched during a strong bull market, and is well received by the public, the price of its stock may rise considerably within a short time, and then suffer the customary reaction. Long range investment possibilities in the stock have to be estimated by the usual methods of analysis; but stocks of this character are still more or less risky owing to the absence of established earning power upon which to form conclusions.

THIRD come reorganizations and consolidations

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whose long range possibilities are to be judged by the same methods that would be employed in analyzing seasoned companies. So far as consolidations are concerned, they are not essentially new companies; for the constituents have established records of earning power, and the management is usually chosen from executives of one or more of the old companies. Reorganizations usually effect little change in a company's status beyond altering the capital structure, and the effect of this upon common stock equities is readily ascertainable by a process of simple arithmetic. It is seldom prudent, however, for either a trader or an investor to buy immediately into the stock of a new consolidation; for expected benefits are usually overdiscounted in the stocks of the old companies before the merger is actually effected, and there frequently follows a period of disappointing earnings before the new organization can be made to function efficiently. The situation as to reorganizations depends upon whether these call for assessments or not. If the reorganization is concluded during a strong bull market, it usually pays both traders and investors to pay the assessment and hold the new securities. Buying into a reorganization, however, is a specialty in itself. Each situation has to be judged on its own merits.

## Expanding Industry

The safest and most profitable plan for both traders and investors, in the long run, is to buy the common stocks of expanding companies in expanding industries. Such stocks, more than any others, are likely to become the giants of the future. So long as earnings continue to expand, a trader is safe in buying stocks on any reasonable reaction, and they may be

## How to Secure Continuous Security Profits

bought at any time by an investor and, if paid for in full and held long enough, will eventually show handsome profits, with practically no risk.

Companies of this character are easily recognized, because they meet most of the following tests:

1. Strong banking affiliations.
2. Capable management.
3. Some monopolistic, or quasi-monopolistic, advantage (such as valuable franchises, patents, advertised trade marks, location, control of natural resources, etc.) This is helpful, but not essential.
4. Large portion of earnings regularly re-invested in the business, thereby financing expansion out of earnings.
5. Large capitalization through growth from small beginnings.
6. Demonstrated ability to earn dividends during off years.
7. Long record of uninterrupted and growing cash dividends.
8. History of frequent stock dividends, split-ups and rights.
9. Low current yield in anticipation of larger dividends to come.
10. Expanding industry.
11. No prospects of coming obsolescence of the industry, or depletion of the company's natural resources.

## CHAPTER XIII

### How to Benefit by Business Changes That Cause Price Movements

**I**N the present chapter we are concerned with profit making opportunities that are afforded by circumstances which cause changes in the prosperity of a great many, if not all, of the country's industries at approximately the same time, as opposed to purely internal conditions which affect the profits of a single industry and those related to it. Fluctuations in general business prosperity afford rich opportunities for both traders and investors, because the prices of securities usually not only reflect these ups and downs, but frequently swing over a wider amplitude than does the curve of general conditions. Traders, of course, may profit by any circumstance which leads to fluctuation in the stock market, and so are no more concerned with the general business outlook than with any of a thousand other factors to which they must give consideration. The investor who buys his securities outright to hold for a few years, however, will find a thorough study of conditions that govern changes in general business conditions of almost inestimable value; because, through such study, he may sometimes be afforded the rare opportunity of acquiring stocks and bonds at rock bottom prices and selling them a few years later with gratifying profits. This plan of buying near the bottom of a major bear market, closing out near the top of the ensuing bull market, and placing the proceeds in short term securities where the money will again be available near the bottom of the next bear market, is a fundamental worthy of every investor's consideration.

## How to Secure Continuous Security Profits

In order to derive the greatest possible profits from major movements in the prices for securities it is important for the investor to familiarize himself with the conditions which cause the correlated business cycle so that he may be able to recognize approximately the best time to buy and to close out, and to know which groups of securities are likely to be most affected by a business depression and the subsequent recovery. Volumes have been written upon the subject, and there is space here to touch only upon the high lights. Readers who wish to pursue the study further will find a brief bibliography, and considerable original material in the valuable report on "*Business Cycles and Unemployment*," submitted in 1923 by the President's Conference Committee on Unemployment, from which quotations below are cited.

"Fifteen times within the past 110 years, American business has passed through a 'crisis.' The list of crisis years (1812, 1818, 1825, 1837, 1847, 1857, 1873, 1884, 1890, 1893, 1903, 1907, 1910, 1913, 1920) shows that the periods between two successive crises have varied considerably in length. Cycles of this sort can be traced, perhaps for two centuries in the Netherlands, England, and France, and for shorter periods in Austria, Germany, Italy, Spain, and the Scandinavian countries. Within a generation or two similar cycles have begun to run their courses in Canada and Australia, South America, British India, and Japan.

"Sometimes the crisis is a mild recession of business activity as in 1910 and 1913; sometimes it degenerates into a panic as in 1873, 1893, and 1907. Sometimes the depression is interrupted by an abortive revival as in 1895, sometimes it is intensified by financial pressure as in 1896 and 1914. Sometimes the depression is brief and severe as in 1908, sometimes it is brief and mild as in 1911, sometimes it is both long and severe as in

## How to Benefit by Business Changes

1874-1878. Revivals usually develop into full-fledged prosperity, but there are exceptions like that of 1895. Prosperity may reach a high pitch as in 1906-1907 and 1916-1917, or may remain moderate until overtaken by a mild crisis as in 1913, or by a severe panic as in 1893.

"These differences among business cycles arise from the fact that the business situation at any given moment is the net resultant of a complex of forces among which the rhythm of business activity is only one. Harvest conditions, domestic politics, changes in monetary and banking systems, international relations, the making of war or peace, the discovery of new industrial methods or resources, and a thousand matters all affect the prospects of profits favorably or adversely and therefore tend to quicken or to slacken the pace of business. The fact that the rhythm of business activity can be traced in the net resultants produced by these many factors argues that it is one of the most constantly acting, and probably one of the most powerful, factors among them.

"To give a sketch of the business cycle which will be applicable to all cases, it is necessary of course to put aside the complicating effects of the various special conditions, from weather to politics, which at any given time are influencing profits, and to concentrate attention upon the tendency of the modern business system to develop alternate periods of activity and sluggishness.

"Analyses of past cycles of business show certain common tendencies. If we begin the analysis when business is reviving, in general the characteristic features are increased volume of manufacturing, rising stock exchange prices followed by rising commodity prices, then by business expansion and increased demand for credit from business men and speculators. As the result of the advance of commodity prices, money rates stiffen and credit gradually becomes

## How to Secure Continuous Security Profits

strained, and these conditions may be accompanied by a curtailment of credit for speculative purposes. Then stock exchange prices fall; for awhile longer general business continues to increase unevenly, transportation facilities are overburdened and deliveries are delayed, the apparent shortage of goods is intensified by speculative buying and duplication of orders by merchants and other buyers until credit expansion nears its limit. Public confidence is then shaken, resulting in widespread cancellation of orders if the cycle is extreme. This is always followed by liquidation of inventories and sharp and irregular fall of prices. During the period of depression there is always more or less widespread unemployment."

### Signs of Recovery

The foregoing describes a typical business cycle. It is especially applicable to the period from 1919 to 1922, which includes the latest severe general business depression and stock market panic up to present writing. As previously pointed out, however, no two cycles are just alike, and the investor must weigh the significance of departures from typical behavior in order to avoid being misled into buying or selling too early or too late. With this precaution in mind, the following typical characteristics by which the beginning and end of a cycle may frequently be recognized will be useful to the specialist in panics.

The costs of doing business will be reduced by falling prices for raw material and by lower interest rates. Manufacturers' inventories and reserves of goods in consumers' hands become liquidated. Postponed consumer demand can wait no longer to replace worn out clothing and furniture. Old machinery has to be replaced. Wants of a steadily increasing population

## How to Benefit by Business Changes

have to be met. Most important of all, investment demand revives, beginning with high grade bonds which may be obtained on a very attractive yield basis; for, though saving slackens, it does not cease. Capitalists become less timid as the crisis recedes into the past, and low interest rates encourage borrowing for capital expenditures and refunding purposes through the issuance of low rate corporation bonds. As the demand for goods increases, more employees are gradually added to the payroll, and the spending of their salaries and wages goes to swell the demand for consumption goods.

The financial characteristics of the ending of a major bear market are a precipitate decline in common stocks, on heavy volume, followed by a sharp rally on short covering, and then a sagging secondary decline. Prices then back and fill within a comparatively narrow trading zone, on progressively diminishing volume. At length there comes a time when the market no longer declines on bad news, and a few stocks here and there commence to rise. Others gradually follow. The bear market is over. In the mean time interest rates have been falling rapidly, and high grade bonds reflect improved conditions in the money market by anticipating stocks in their recovery.

## The Culmination of Prosperity

Conditions bred by prosperity eventually set up internal stresses within the economic structure which bring about a reversal in the business cycle. Among these stresses are the mounting costs of doing business, resulting from higher costs of raw material, higher interest rates on borrowed capital, the impressing of antiquated and inefficient equipment into service to handle peak orders, the rising cost of labor per unit of output, and the accumulation of numerous small

## How to Secure Continuous Security Profits

wastes arising from haste to fill orders and the overworking of department heads and executives.

A number of concerns can offset this mounting cost of doing business by raising the prices of goods they sell; but an important minority, which grows larger as the boom approaches its apex, are not able to do this and so their profits grow smaller and smaller. "There are certain lines in which selling prices are stereotyped by law, by public commissions, by contracts of long term, by custom, or by business policy. . . . There are other lines in which prices are always subject to the incalculable chances of the harvests, and in which the market value of inventories wavers with the crop reports. There are always some lines in which the recent construction of new equipment has increased the capacity for production faster than the demand for their wares has expanded under the repressing influence of the high prices which must be charged to prevent a reduction of profits."

"The unwillingness of producers to let fresh contracts threatens loss not only to contracting firms of all sorts, but also to all the enterprises from whom they buy materials and supplies. The high rates of interest not only check the current demand for wares of various kinds, but also clog the effort to maintain prices by keeping large stocks of goods off the market until they can be sold to better advantage."

"As prosperity approaches its height, then, *a sharp contrast develops between the business prospects of different enterprises*. Many, probably the majority, are making more money than at any previous stage of the business cycle. But an important minority, at least, faces the prospect of declining profits. The more intense prosperity becomes, the larger grows this threatened group.

"Now such a decline of profits threatens worse con-

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sequences than the failure to realize expected dividends, for it arouses doubt concerning the security of outstanding credits. Business credit is based primarily upon the capitalized value of present and prospective profits, and the volume of credits outstanding at the zenith of prosperity is adjusted to the great expectations which prevail when the volume of trade is enormous, when prices are high, and when men of affairs are optimistic. The rise of interest rates has already narrowed the margins of security behind credits by reducing the capitalized value of given profits. When profits themselves begin to waver, the case becomes worse. Cautious creditors fear lest the shrinkage in the market rating of the business enterprises which owe them money will leave no adequate security for repayment; hence they begin to refuse renewals of old loans to the enterprises which cannot stave off a decline of profits, and to press for a settlement of outstanding accounts.

"Thus prosperity ultimately brings on conditions which start a liquidation of the huge credits which it has piled up. And in the course of this liquidation, prosperity merges into crisis."

The present upward swing of business, which is now in its eighth year, is noteworthy for the unusual length of time it has persisted without any appreciable rise in the general price level of commodities. This is largely to be explained by the excess production capacity which was left us as a heritage of the War, and the exceptional amount of credit and liquid capital that has been available to finance further expansion of plants. Of recent months the rise in interest rates has made it more difficult for small enterprises to finance their needs, and the results of this are already being reflected in diminished profits and falling prices for their securities. Large companies, however, are not as yet

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handicapped by high interest rates; for their common stocks find a ready market, and their profits are supplemented by returns from the call market in which their surplus cash is loaned. Under present Federal Reserve policies, moreover, staple commodities which can be financed by acceptances are being moved to market without hindrance from high interest rates. As might be expected, this state of affairs is being reflected in the stock market, where the common stocks of our larger corporations are registering new highs daily at the same time that stocks of less favorably situated companies have been declining—some of them very drastically.

Normally, high and persistently rising interest rates on stock exchange collateral, accompanied by extensive declines in the stocks of weaker companies and a recession in bond prices would mark the culmination of a major bull market and point to an approaching business depression; but there are several new factors in the present situation which suggest caution in drawing such a momentous conclusion. The present credit stringency has been largely fostered by Federal Reserve policies which could, and probably would, be reversed in time to avert a serious crisis. The rapid increase in "loans for others" has rendered it unlikely that funds to finance the stock market will become wholly unavailable as used to happen in former bull markets. Our high interest rates are continually drawing gold from other countries to cushion the financial stringency, so that the situation is fraught with greater danger to European industry than to our own. During the past decade, too, the concentration of business into large units has progressed to the point where it is doubtful if the distress of smaller enterprises would react so unfavorably upon the profits of our great corporations as it has in former crises, especially in the absence of

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swollen inventories. Varied circumstances such as the foregoing merely serve to emphasize the necessity of judging each situation according to current events. There is no universal formula that will exactly fit all cases.

### Selective Action of Crises

Business depressions do not affect all industries, nor even all companies within the same industry, in the same manner; nor are all sections of this great country injured in the same degree, or at the same time.

Ordinarily, concerns engaged in the extractive and lumber industries are hardest hit—so much so, indeed, that it has hitherto been difficult for companies such as the steel manufacturers to get squarely onto their feet after one crisis before the foundation is knocked out from under them by the next depression. Companies such as leather and tire manufacturers, which are obliged at all times to carry heavy inventories, are also always severely hurt by falling prices. In general, it may be said that manufacturers suffer most, and public utilities least of all. In fact the railroad and public utility companies, notably the latter, may actually benefit by a severe business depression; for the consequent small loss in gross income is usually more than offset by marked reductions in practically all the items that enter into the cost of operation. Gold mining companies are also benefited by general business depressions, especially when these result in lower wages. Enterprises which cater to people who strive to economize may even report improved earnings during years of general business depression, and the same applies to the producers of necessities. Among these so-called “depression proof” industries are the five and ten cent stores, cafeterias and other low priced restaurants, the

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lower price movie theatres, baking companies, soft drink and proprietary medicine companies whose products are marketed at a fixed price, ice companies during years of abnormally high temperature, and, of course, the public utilities. The comfort and luxury industries usually suffer a marked falling off in profits. These include, among others, such goods as jewelry, furs, rugs, automobiles, radio, and clothing.

### Specializing in Panics

So far as the investor is concerned, such analyses which separate the depression proof industries from those which are likely to be most adversely affected is of less practical value than might be supposed. In a major bear market the prices of all securities decline, though some suffer less than others. If the reader will take the time someday to consult the financial records of the drastic bear market of 1920-1, he will find it highly instructive to note the severity of the maximum declines in what are generally classed as high grade stocks and bonds. In some instances these actually suffered more than the issues of less highly rated companies.

The conspicuous lack of discrimination toward the end of a major bear market arises partly from the fact that people are obliged to dispose of all classes of securities to raise cash, and partly from the fact that second and third rate securities, which lead the decline, have already been nearly liquidated before high grade issues are subjected to their greatest pressure. Among common stocks, however, high grade issues are generally the last to give way and the first to recover; so that the panic buyer will find it not only safest but also more profitable to confine his earlier purchases to the common stocks of large and well seasoned corporations

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which have demonstrated their ability to maintain dividends through previous periods of depression and subsequently to rebound to new heights. There should be no haste about acquiring the lower grade issues, but keen bargain hunters have always been quick to snap up the good stocks after a panic. It is quite possible, however, that high grade common stocks may not suffer so severely in the next panic on account of the stabilizing influence of the numerous investment trusts which have been formed within recent years, and which are ever on the lookout to acquire high grade common stocks at bargain prices.



## CHAPTER XIV

### Trading Opportunities in Investment Issues

#### High Grade Securities

**D**URING the upward swing of a major market cycle frequent opportunities are presented to buy high grade investment securities and close them out at a profit after holding for only a few weeks or months. The term, "high grade bonds and preferred stocks" is generally understood to cover issues that have earned their fixed interest or dividend payments by a good margin, even during the poorest years, and which are secured by assets worth several times their par value. High grade, or the so-called "investment," common stocks comprise the equities in large corporations which maintain dividends during poor years and show a generally rising trend in earnings over a period of several business cycles. The present discussion will be limited to high grade bonds and preferred stocks, however; since trading opportunities in common stocks of the investment class differ little from those in other common stocks, which are covered elsewhere in this volume.

It would be superfluous to remind the reader that the market prices of even high grade bonds and preferred stocks continually fluctuate in price though, excepting convertible issues, within a narrower range than is usually traversed by securities of lower rating. This is an inevitable consequence of their being listed in a free and open market in which investors throughout the civilized world may register their opinions and needs

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by buying and selling. The price fluctuations that may be observed in high grade bonds and preferred stocks—securities upon which the rate of disbursement is fixed—are usually attributable to changes in the rental value of money; changes in earnings; changes in supply of, and demand for, the issue; and, in the instance of convertible securities, fluctuations in the market price of the common stocks into which they are convertible.

### Influence of Interest Rates

It was shown in Chapter IV that securities which pay a fixed rate of disbursement should, in order to sell on a true yield basis that is in line with current rates for time money, rise in market price during periods of high interest rates and decline gradually when time money is cheap. By behaving in this manner, bonds and preferred stocks would simply be discounting coming changes in interest rates, much after the fashion of common stocks which actually do strive to discount coming developments. Thus a preferred stock which enters a period of 8% time money with an apparent, or current, yield of 6% should rise 2% in market price during the year in order to bring the true yield up to 8% (6% from dividends plus 2% in market profits). Similarly, 4% time money should cause a preferred stock with current yield of 6% to drop 2% a year in market price, thereby producing a true yield of 4% (6% from dividends, less a market loss of 2%).

In practice, high grade bonds and preferred stocks deport themselves marketwise in just the opposite way. They decline during periods of high interest rates and advance when time money is cheap. And so the true yield on such securities, taking profits and losses into the reckoning, is actually very small or less than nothing when time money is rising, and very large when

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interest rates are low or falling. The reasons for this contradiction between what ought to be and what is are threefold:

In the FIRST place, high grade bonds and preferred stocks are still purchased largely by investors for income only, rather than for speculation, and so have to compete on a current yield basis with prevailing rates in the money market. In the SECOND place, interest rates rise when money is scarce and people have to sell securities in order to supply themselves with cash; whereas low interest rates betoken a plethora of idle funds, and as this money finds its way into the investment market the prices of high grade securities naturally rise. And FINALLY, caution and apprehension bring about a good deal of liquidation in high grade bonds and preferred stocks on the part of investors who have learned to look upon rising interest rates as a premonitory symptom of coming business troubles; whereas low and falling rates for money are customarily regarded as favorable business omens and so inspire investors with confidence.

Other conditions being equal, then, *good profits can be made by buying high grade stocks and bonds when rates for money are high, and disposing of them after money becomes cheap again.*

### Influence of Profits

At first thought it might be supposed that, if a company has demonstrated its ability during business depressions of the past to earn by a safe margin the fixed payments on its senior securities, subsequent fluctuations in earnings would exert little influence upon the prices of such issues. This might be the case if investors could look into the future with certainty and divest themselves of fear and hope; but, in the world

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as we find it, people can judge the future only by the past and present, and a period of receding earnings always leads a certain number of timid holders to fear that earnings might continue to drop to a point where interest and dividend payments might be jeopardized. It is this precautionary selling by timid investors that depresses high grade issues when earnings are falling off, and renewed buying that brings about a recovery in prices when earnings again begin to increase.

An experienced analyst can usually sense whether a decline in earnings is merely temporary or due to some fundamental change in the company's affairs which may eventually undermine the safety of its senior securities. If the condition is merely temporary, good trading profits may be realized by buying high grade securities on recessions caused by a comparatively brief period of comparatively poor earnings. In a general way, however, it may be said that the securities of companies whose earnings fall off for two or more consecutive years should not be purchased until there are pretty definite indications that the trouble is over, regardless of optimistic forecasts that may be issued by the company's executives, who are often too prone to minimize the seriousness of permanent changes for the worse. Furthermore, abnormally high current yields of, say, 2% above what would be normal for a given security under prevailing conditions in the money market are in themselves warning signals for investors to investigate with unusual care before buying. On the other hand, an abnormally low yield of, say, 2% below what would be normal for a fixed income bearing security would serve as an indication that opportunities for further market profit in such an issue had about been exhausted; so that it would be better to switch into some other security which is more attractively priced.

It is important to take seasoning influences into con-

## Trading Opportunities in Investment Issues

sideration in judging whether a high grade bond or preferred stock is selling at an attractive or unattractive yield. Recently issued securities sell on a comparatively high yield basis. But as the company demonstrates its ability with the passing of time to earn its fixed charges by a comfortable margin, even during lean years, the prices of its senior issues tend to rise higher and higher—especially if earnings show a marked tendency to go on increasing from one business cycle to another. A striking instance of this at present writing would be U. S. Steel 7% Preferred which, at 140, yields only 5% in a 9% time money market; and Otis Steel 7% Prior Preferred which, at 100, yields 7%. If Otis can maintain its present rate of progress for a period of years, the preferred stock will undoubtedly appreciate gradually in market price, especially when money becomes easier.

### Influence of Supply and Demand

The current price movement of any stock or bond depends upon whether buyers or sellers preponderate at the time. This is merely the old Law of Supply and Demand, at work in the securities market. There are occasions when unwarranted fright, the circulation of false adverse rumors, or perhaps the liquidation of an estate that has held a large block of some particular issue, may afford rare opportunities to the bargain hunter. The assassination of President McKinley, which many readers will recall, was a conspicuous case in point.

Traders who wish to take advantage of opportunities created by all three of the foregoing influences will find it worth while to keep charts of price changes in a number of the more active high grade stocks and bonds, together with a graph of 90-day time money. By carrying

## How to Secure Continuous Security Profits

these graphic records back for a few years (weekly closing prices are ordinarily sufficient for this purpose), it will be observed that price fluctuations in many of these issues are confined within rather definite upper and lower limits which lie upon fairly smooth boundary curves. In the instance of issues which are undergoing a process of seasoning during the progress of a prolonged bull market, these boundary curves will evince a marked tendency to turn upward. In other words, each new high will tend to exceed the previous one, and the subsequent low point will be above the one before. By purchasing as prices reach the lower boundary curve, and closing out near the upper curve, traders may be able to make several profitable turns a year in the more active high grade issues.

Traders who specialize in this field sometimes keep a price record of the common stock on the same chart with the senior issues; for the latter tend to follow fluctuations in the junior issue, though on a much reduced scale. Trading in high grade bonds and preferred stocks is not so exciting as speculation in common stocks, but the business is much less risky. If you are "hung up" in a good bond or preferred stock, the price is almost sure to come back eventually, and you can enjoy a reasonable income from interest or dividends in the meantime.

### Convertibles

Indulging in a little poetic license, we shall include under this heading not only bonds and preferred stocks which are themselves convertible into other issues, but also securities which carry option warrants entitling the owner to purchase other issues at a specified price. For present purposes, moreover, we shall confine the discussion to bonds and preferred stocks which are

## Trading Opportunities in Investment Issues

convertible into, or entitle the owner to purchase, common stocks. These are by far the most common types.

Obviously either of these privileges will at times endow fixed income bearing securities with pronounced speculative characteristics. Take the New York, New Haven & Hartford deb. 6s of 1948, for example, which are convertible into common stock at 100. These are now selling at 133, with the common stock priced at 120, and paying 4%. The deb. 4s, which are not convertible, now sell for about 75. On their investment merits alone, the 6s would thus be worth about  $112\frac{1}{2}$ , which makes the conversion privilege worth  $20\frac{1}{2}$ , and this happens to be approximately the amount by which the common stock exceeds its parity of conversion. It is to be expected, then, that so long as interest rates remain at the present level, each change of a point in the market price of the common stock will be accompanied by a corresponding change in the market price of the bonds. Should the common stock drop below 100, however, the bonds would become stabilized at around  $112\frac{1}{2}$ . Two years ago, when the common stock was selling at only 50, the bonds brought about 113.

In the foregoing illustration, the bond sells considerably above the stock into which it is convertible, so that the investor would lose something in both principal and income by converting. This is doubtless due to expectations that the common dividend will soon be raised, and that the stock is destined to go higher in the near future. It illustrates of the general principle that prudent investors never actually convert their bonds into stock unless, for one reason or another, the privilege is about to be withdrawn. If it is believed that the common stock is slated for higher prices, just as big speculative profits can be made by holding the bond as the stock; but if the stock should happen to decline below conversion parity and reduce its dividend

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materially, the loss in both principal and income would be much greater to stockholders than to bondholders.

The advantage, then, in buying a convertible fixed income bearing security, instead of the common stock, is that the trader can speculate in this way with a limited risk, but with unlimited chances for profit.

Ordinarily, convertible and option warrant securities sell at prices which bear a more or less logical relation to the prices of stock into which they are convertible. Occasionally, however, the market may overlook for awhile some security of this class which is obviously out of line. In its issue of March 15, 1929, the "*Investment and Business Forecast*," an advisory service for traders and investors, published weekly by THE MAGAZINE OF WALL STREET, called attention to a rare opportunity of this character from which subscribers derived a quick profit. It was the Walworth Company's 10-year, Sinking Fund, Series "A," 6½% Debentures, Due October 1, 1935. These bonds, which were then selling around 99, carry warrants entitling the owner to purchase ten shares of the Company's common stock, any time on or before January 1, 1936, at a price of \$30 per share for each \$1,000 debenture. The common stock was then selling around 42.

Before buying convertible or warrant securities, especially if one expects to hold them for any considerable length of time, it is very important to scrutinize the provisions under which they were issued. For what issue may the security be exchanged? Who has the option of conversion—the corporation or the certificate owner? Within what time limits may the privilege be exercised? What is the conversion ratio? When is the security callable or redeemable, if at all, and at what price?

Convertible bonds, or those issued with warrants, are usually debentures unsecured by mortgage. The

## Trading Opportunities in Investment Issues

privilege that goes with such bonds is too often tacked on to make an issue sell for more than its worth as a simon pure investment. For this reason preferred stocks with privileges are more likely than bonds to show speculative profits if held for a term of years. The debenture bond is in itself often an indication that the issuing company's credit standing was none too high at the time, although it may improve later.

### Conclusion

In the foregoing chapters we have attempted to place before the reader some of the more important plans by which successful traders and investors make money in the stock and bond market. It is hoped that these will prove helpful; but it is always well to bear in mind that experience, years and years of learning first hand what to do and what to avoid doing, is the best teacher. People differ greatly in aptitude. A method of operation that would prove profitable in some hands would be disastrous in others, and *vice versa*. Neither is it possible to devise general rules that will apply to all situations. Conditions are always changing, were it not so there could be no price movements—no profits nor losses. To be successful in Wall Street a person must use his head, and, above all, keep posted on new developments.

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